

French law for the safe harbour are: (1) the firm structural establishment of the group; (2) the existence of a coherent group policy; and (3) an equitable distribution of the revenue and costs of the business among the members of the group.<sup>185</sup> It has been said of the French position that no group transaction is forbidden so long as there is some 'quid pro quo', though not necessarily an exact counterbalance.<sup>186</sup> However, support provided by a group company must not exceed what can reasonably be expected from it, so that where support is beyond the provider's financial capacity, it will be considered unlawful.<sup>187</sup> The Commission saw the introduction of such a rule as an important step towards improved business efficiency and competitiveness, but it stressed that appropriate safeguards would have to be carefully designed. The Commission's stated intention in 2003 was for a proposal for a framework Directive to this effect to be presented in the medium term. However, this proposal and other related ideas, such as the possibility of introducing a Community consolidated approach to group insolvencies,<sup>188</sup> do not appear to have received much attention since then, which suggests that they may have been sidelined.<sup>189</sup>

<sup>185</sup> Kraakman *et al.* (n 178 above) 86–7.

<sup>186</sup> Wymeersch (n 177 above) 573, 591.

<sup>187</sup> E. Wymeersch, 'Conflicts of Interest in Financial Services Groups' (forthcoming 2008, *Journal of Corporate Law Studies*).

<sup>188</sup> By the High Level Group: European Commission, 'Report of the High Level Group of Company Law Experts on a Regulatory Framework for Company Law in Europe' (Brussels, November 2002) 98.

<sup>189</sup> T. Baums, 'European Company Law Beyond the 2003 Action Plan' (2007) 8 *European Business Organization Law Review* 144.

### 3

## Capital Structure—Fundamental Legal, Accounting, and Financing Considerations

### Scope of this chapter

The legal rules governing the financing of companies are the primary focus of this book. As a prelude to the more detailed examination that follows in later chapters, the purpose of this chapter is to outline the basic components of the capital structure of a company and to consider, in a rudimentary way, some of the factors that may be taken into account by the managers of a company when making financing choices. Simple illustrations of the way in which financing choices have to be recorded in a company's accounts are provided. A company's accounts play a key role in determining compliance with legal requirements on corporate capital. By giving historical information about previous financing choices and the performance of the company, the accounts also provide important investment information.

There are basically three ways for a company to finance its operations: share issues, debt, and retained profits. In an introductory exposition such as this, it is convenient to take the simplest type of share and to compare its standard features with those of the simplest type of debt instrument. This should not be allowed to obscure the great flexibility that exists in practice with regard to the characteristics of financial instruments issued by companies. It is possible to issue shares which, by their terms of issue, deviate significantly from the standard case, to structure debt so as to mimic the characteristics of share capital, and to devise instruments which combine some of the features of share capital and of debt. Devising innovative financial instruments that tap into particular investor preferences in changing market conditions is a significant part of corporate finance advisory activity.

### Share capital terminology

There are many different types of share, including ordinary shares, preference shares, and redeemable preference (or ordinary) shares. The ordinary share is the most straightforward type of share.

The *allotted share capital* of a company is the amount of share capital that has been allotted by a company at any time. This amount may also be described as the company's *issued share capital*. Allotted share capital/allotted shares and issued share capital/issued shares are not precisely synonymous terms but, save for certain specific contexts where the differences may matter (such as the interpretation of a tax concession available in respect of 'issued' share capital), they can, and frequently are, used interchangeably. The terms *shareholder* and *member* are also often used interchangeably even though, again, there are certain technical differences between them.<sup>1</sup> The same is true of *equity share capital*: this term carries a precise meaning in particular contexts (such as that of the Companies Act 2006)<sup>2</sup> but it is often used in a looser sense to mean the same as share capital or, in the shortened form of *equity*, to mean share capital, other undistributable reserves and retained earnings.

A company limited by shares, whether public or private, is formed by one or more persons subscribing their names to a memorandum of association and complying with the requirements of the Companies Act 2006 with regard to registration.<sup>3</sup> The effect of these requirements is that the minimum number of allotted (or issued) shares in a company limited by shares is one. Prior to the Companies Act 2006, one-member, one-share public companies were not possible because the minimum requirement was for at least two members, each of whom had to agree to take at least one share. There is no regulation of the minimum overall amount of a private company's allotted share capital but for a public company there is a minimum of £50,000.<sup>4</sup>

Shares must have a *par* (or nominal) value ascribed to them in the statement of capital that a company must file with the registrar of companies on formation and whenever its capital is altered thereafter.<sup>5</sup> The par value sets the minimum allotment price.<sup>6</sup> Shares may be allotted at a price that is more than their par value. The difference (if any) between the par value of a share and the allotment price is known as a *share premium*.

Shares may be allotted on a fully, partly, or nil paid basis.<sup>7</sup> The amount paid up in respect of the par value of shares (ie excluding premiums) represents a company's *paid up share capital*. Where shares are allotted otherwise than on a fully-paid basis, payment dates may be set by the terms of allotment or the company's constitution (ie its articles of association); alternatively, it may be left to the

<sup>1</sup> Companies Act 2006, s 112 defines who are the members of a company.

<sup>2</sup> Ibid s 548. This definition generally excludes preference shares, except where such shares are also participating with respect to dividends or/and capital. Another context where 'equity' carries a technical meaning is in accounting; see International IAS 32, *Financial Instruments: Disclosure and Presentation* and IAS 39, *Financial Instruments: Recognition and Presentation*. Depending on their specific terms, preference shares may be classified as equity instruments or financial liabilities for accounting purposes.

<sup>3</sup> Companies Act 2006, s 7.

<sup>4</sup> Ibid ss 761 and 763.

<sup>5</sup> Ibid s 10 refers to the statement of capital that must be filed on formation.

<sup>6</sup> Ibid s 580.

<sup>7</sup> These, and other terms mentioned in this paragraph, are considered in more detail in ch 4 below.

discretion of the directors to call for payment in accordance with the articles. A company's *called up share capital* is made up of the share capital that has been paid up plus any amounts in respect of share capital (ie excluding premiums) that have been called up or are due on specified future dates. Allotted share capital which has not been called up is *uncalled share capital*.

In respect of private companies, company law in the UK does not require a specific minimum amount of share capital actually to be invested in the business before trading commences. In recent years, this feature of the law has put the UK at a competitive advantage compared to other European countries whose laws impose minimum capital requirements on private companies because it means that businesses can incorporate relatively cheaply in the UK and then operate elsewhere in the Community under EC Treaty freedoms in respect of cross-border activities.<sup>8</sup> To the extent that there is a direct *ex ante* constraint on UK private companies trading on minimal amounts of share capital, it is lending practice rather than law: banks may be reluctant to lend to a private company if its proprietors have not themselves demonstrated their confidence in the company's prospects by taking the risk of investing a substantial amount in its share capital. UK law relies more on *ex post* constraints: should a company that has started trading with an inadequate equity capital base fail, its financing structure may be a factor for the court to take into account in proceedings against its directors.<sup>9</sup>

The position is different in relation to public companies, which are required to have a paid up share capital of at least £12,500 before they start trading.<sup>10</sup> Whilst not completely trivial, this is hardly a significant amount. More powerful factors in determining the size of a public company's equity capital base stem from commercial pressures to maintain a balance between debt and equity ('gearing' or 'leverage') that is acceptable to lenders and investors.

### Accounting for an allotment of shares

When a company allots shares for cash at their par value, this will be recorded as an increase in the company's current assets and as an increase in share capital.<sup>11</sup> In numerical terms, it will look like Table 3.1 below. The amount shown in a company's accounts as its share capital is subject to the legal rules on maintenance of capital.<sup>12</sup> The maintenance of capital principle operates as a trade-off for limited

<sup>8</sup> See further ch 4 below.

<sup>9</sup> *Re Purpoint Ltd* [1991] BCC 121, 127 *per* Vinelott J.

<sup>10</sup> This requirement follows from the combination of the minimum capital requirement of £50,000 (Companies Act 2006, s 76(1)) and the rule that shares in public companies must not be allotted except as paid up at least as to one-quarter of nominal value (Companies Act 2006, s 586); ie  $50,000/4 = 12,500$ .

<sup>11</sup> This discussion is in relation to ordinary shares or other shares that for accounting purposes are classified as equity instruments. The position is more complex in relation to shares that for accounting purposes are classified as financial liabilities: P Högberg, *Accounting Principles for Lawyers* (CUP, 2006) 151–4.

<sup>12</sup> Discussed in ch 7 below.

liability: shareholders cannot be held liable to contribute to the company's assets for more than they have undertaken to subscribe in respect of their shares, but in return the amounts subscribed must be maintained. 'Maintenance' in this context essentially means 'not returned to the shareholders'.<sup>13</sup> It is not a breach of the maintenance of capital principle for a company's share capital to be wiped out by improvident trading or bad investment decisions, although such events may trigger insolvency proceedings in relation to the company.

When shares are allotted at a premium to their par value, the share premium must be credited to a separate account, as illustrated by Table 3.2 below.

Table 3.1. Accounting for an allotment of shares at par value

Pre-allotment of new shares	
<i>Assets</i>	£m
Cash	5,000
<i>Financing</i>	£m
Share capital	5,000
Reserves	4,000
Post-allotment of 10m new £1 shares at par to investors who pay cash	
<i>Assets</i>	£m
Cash	5,010
<i>Financing</i>	£m
Share capital	5,010
Reserves	4,000

Table 3.2. Accounting for an allotment of shares at a premium

Pre-allotment of new shares		
<i>Assets</i>	£m	£m
Cash	8,000	8,000
<i>Financing</i>		
Share capital	2,000	8,000
Other reserves	6,000	
Post-allotment of 10m new £1 shares at £2 per share		
<i>Assets</i>		
Cash	8,020	8,020
<i>Financing</i>		
Share capital	2,010	
Share premium	10	
Other reserves	6,000	8,020

With only a few exceptions, sums credited to a share premium account are subject to the maintenance of capital principle in the same way as paid up share capital.<sup>14</sup>

### Characteristics of ordinary shares

The standard characteristics of an ordinary share relate to entitlements in respect of dividends, capital growth, and participation in internal governance through voting.<sup>15</sup>

#### Dividends

Dividends are distributions to shareholders that are made out of the company's distributable profits. A company that does not have profits available for distribution cannot pay dividends. Moreover, even where distributable profits are available, the holders of ordinary shares have no absolute entitlement to demand that dividends be paid. The payment of dividends is governed by a company's articles, which normally authorize the directors to pay interim dividends at their discretion where they consider that this is justified by the company's profits, and provide for final dividends to be declared by the shareholders in general meeting on the basis of a recommendation from the directors. As a matter of legal theory, it is possible for a company to pay dividends on its ordinary shares which fluctuate widely from year to year. It is also open to a company not to pay any dividends at all and to plough back the entire profits into the future funding of its operations. Both of these possibilities give way, in practice, to commercial considerations which may, depending on its nature or the sector in which it operates, require a company to pay steady dividends out of its distributable profits in order to satisfy the expectations of investors.<sup>16</sup> Dividends are paid out of a company's post-tax profits.

#### Capital gains and risk

When a company is wound up, the holders of its ordinary shares are entitled to any surplus that remains after all the liabilities have been paid. This means that the ordinary shareholders of a company may be described as its 'residual claimants' or, in legal terms, as its owners. The entitlement to eventual capital gains

<sup>14</sup> Companies Act 2006, Pt 17, ch 7. The implications of this are discussed further in ch 4 below.

<sup>15</sup> The financial incidents of ordinary shares are considered in more detail in ch 6 below. This chapter provides an overview.

<sup>16</sup> See further ch 9 below.

<sup>13</sup> *Tenor v Whitworth* (1887) 12 App Cas 409, HL, 414 per Lord Herschell; this analysis is echoed by Lord Watson at 423-4.

is reflected in the price at which its shareholders can sell their shares during the life of the company. On the other hand, however, as residual claimants or owners, investors in ordinary shares assume significant risks because they are the last to be paid in a winding up and, hence, will be the first to absorb any shortfall in the company's assets. Investors in ordinary shares will expect a return that is adequate to compensate them for the risk that they will not be repaid in the event of winding up.

### Voting rights

Ordinary shares usually entitle their holders to one vote per share. It is possible to have non-voting ordinary shares or ordinary shares which carry multiple votes but their distorting effect on the operation of the market for corporate control (ie voting control of the company does not necessarily follow from acquiring the majority in number of its shares) and on corporate governance mechanisms, which are based on the control that shareholders can exercise through their votes, means that weighted voting shares are unpopular with institutional investors in the UK.<sup>17</sup> Participants in quasi-partnership type companies or joint venture companies may favour multiple voting rights as a means of entrenching their original bargain. One familiar form of multiple voting provision used for entrenchment purposes is a clause that is triggered by a proposal to remove a shareholder from the office of director and which provides that, in that event, the votes attaching to the shares held by that shareholder will be multiplied to an extent that is sufficient to defeat the motion.<sup>18</sup>

### Debt finance terminology

A company can borrow from banks or other lenders or can tap the capital markets by issuing debt securities to investors. The raising of capital by an issue of debt securities is sometimes described as direct financing because the company appeals directly to investors; bank borrowing is in turn described as indirect financing because the bank stands between the company and the providers of the funds; namely the bank's depositors and persons from whom it has raised capital via the capital markets.

<sup>17</sup> See generally Institutional Shareholder Services, Shearman & Sterling and European Corporate Governance Institute, Report on The Proportionality Principle in the European Union (May 2007) (study commissioned by the European Commission) available at [http://www.ecgi.org/osov/documents/final\\_report\\_en.pdfs](http://www.ecgi.org/osov/documents/final_report_en.pdfs) (accessed December 2007). Issues relating to 'one share—one vote' (the proportionality principle) are considered further in ch 13 below.

<sup>18</sup> This is commonly described as a *Bushell v Faith* clause after the House of Lords decision that sanctioned it: [1970] AC 1099, HL.

There are many different types of debt instrument that companies use to raise funds from the capital markets. The terminology used to describe debt instruments tends to be driven more by market practice than by legal definition and is thus liable to fluctuate from market to market and from time to time in response to practical developments. Markets devise terms to distinguish debt securities by reference to certain key characteristics such as duration (for example the term 'commercial paper' is commonly used to describe short-term debt securities, whilst long-term debt securities are often called 'bonds') and whether they are secured (sometimes described as 'debentures') or unsecured (often known as 'loan stock'). Terminological variety is a particular feature of the markets in specialist debt securities which are normally bought and traded in by limited numbers of expert investors.

The term *debenture* also crops up in the context of bank financing for companies. Here it tends to be used to describe a loan which is secured on the company's property. In confining the use of the term *debenture* to secured loans, practice is narrower than legal usage. There is no exhaustive legal definition of the term *debenture*<sup>19</sup> but a commonly cited description is that it encompasses any document which creates or acknowledges a secured or unsecured debt.<sup>20</sup>

Borrowing from banks and other lenders and issuing debt securities to investors are not the only ways in which companies can raise external non-equity finance to fund their operations. Companies can obtain short-term trade credit by acquiring goods on credit terms; sellers may supply goods on an open account or may require assurance as to payment in the form of documentary credits issued by banks and/or security by means of provisions that reserve title to the goods in the seller until payment.<sup>21</sup> Other asset financing mechanisms include finance leases, hire purchase, and arrangements such as 'repos', which are transactions in which a company sells assets but with an option to re-acquire them, that in functional or economic terms are the same as loans but which are in a different legal category.<sup>22</sup> In addition there are many types of receivables financing that companies can use to improve their cash flow by enabling them to obtain funds

<sup>19</sup> Companies Act 2006, s 738 lists various instruments which are debentures but the list is not closed. The absence of a precise definition has given rise to few practical problems: *Re SH & Co (Radiations)* 1990 Ltd [1993] BCC 60, 67.

<sup>20</sup> *Ley v Abercrombie, Stale and Slab Co* (1887) 37 Ch D 260. See also *Edmonds v Blainie Furnaces Co* (1887) 36 Ch D 215; *Lennon v Austin Friars Investment Trust Ltd* [1926] 1 Ch 1, CA; *Knightbridge Estates Trust v Byrne* [1940] AC 613, HL; *R v Findlater* [1939] 1 KB 594, CCA; *NV Slatenburgh's Bank v Intercontinental Natural Resources Ltd* [1980] 1 All ER 955.

<sup>21</sup> On retention of title (RoT) clauses generally, see G McCormack, *Secured Credit under English and American Law* (CUP, 2004) ch 6.

<sup>22</sup> Asset sales achieve the same economic effect as secured loans but avoid the Companies Act 2006 requirements for the registration of charges. An attempt to avoid the registration requirements by labelling a structure as a sale will not work if the legal substance of the arrangement is in fact a secured loan: *Walsh Development Agency v Export Finance Co Ltd* [1992] BCC 270, CA. On repos see further, Law Commission, *Registration of Security Interests: Company Charges and Property Other Than Land* (Law Com CP No 164, 2002) para 6.38.

more quickly than through awaiting payment from customers for goods supplied on credit. One type of receivables financing is debt factoring, where receivables (trade debts) are sold to a factor which then collects the debts, either on a recourse basis (where the factor has recourse to the company should customers fail to pay) or a non-recourse basis (where the factor in effect provides bad debts protection); another is block discounting, where debts are sold for an immediate cash payment by the discountor but ordinarily the company continues to collect the debts, acting as agent for the discountor.<sup>23</sup> Certain types of businesses are not thought suitable for receivables financing: it is useful for businesses operating in sectors that generate trade debtors, such as manufacturing and wholesale distribution, but less so for businesses that sell to the general public or otherwise for immediate settlement.<sup>24</sup> Reasons of space preclude separate consideration of asset and trade financing in this book.<sup>25</sup>

### Characteristics of simple debt

#### Interest

The rate of interest payable in respect of a loan is determined by the contract between the company and the lender. The rate of interest may be fixed or may be floating and, as such, liable to be adjusted in specified circumstances. Unlike dividends, interest is normally payable whether or not the company makes profits. Interest is deductible from the company's pre-tax profits and thus goes to reduce the profits on which the company is liable to pay tax. The favourable tax treatment is one factor that makes debt a potentially cheaper source of finance for a company than share capital.

#### Capital gain and risk

A creditor is entitled to the repayment of the principal amount of the loan at the end of its term, but this is normally the limit of the creditor's claim against the company. Creditors do not share in a company's capital growth. The opportunity for capital gains for investors in debt securities lies in exploiting differences between the yield on the securities, measured by reference to their cash flows in the form of interest payments and principal repayment at maturity, and the interest rates prevailing in the market. Where the yield on debt securities is higher

than market interest rates, an investor may be able to sell the securities at a premium to their face value and thereby obtain a capital gain.

Providers of debt finance rank above shareholders for repayment in the event of winding up. There is also a ranking order between debts depending on whether they are secured or unsecured and, if secured, the type of security. Certain types of debt are given a preferential ranking status by the insolvency legislation,<sup>26</sup> whilst others are deferred.<sup>27</sup> Priority over share capital in winding up is another factor that reduces the cost of debt finance in comparison to share capital: providers of debt finance accept less risk and that is reflected in the return that the company has to pay for financing in this form. However, in a highly leveraged firm, low ranking holders of debt occupy a residual position akin to that of shareholders because they will be first to absorb losses after the equity has been exhausted.

#### Control

Covenants, which are contractual restrictions in the terms on which debt capital is provided, are in a broad sense the debt finance equivalent to the control that shareholders are entitled to exercise via the votes attaching to their shares. The precise extent of the restrictions imposed contractually through covenants is fact-specific and dependent on a range of variables, including the length of the period for which the finance is to be available, whether it is privately negotiated or is raised directly from the capital markets, and whether it is secured or unsecured. General economic conditions are also relevant, as evidenced by 'covenant lite' financing transactions entered into in 2006–07, a period of great buoyancy in credit markets.<sup>28</sup> Covenants may include limitations on the company's borrowing levels, restrictions on the payment of dividends, negative pledge clauses whereby the company promises not to grant any new security on its property and provisions restricting disposals of the company's property or major changes in the nature of its business.<sup>29</sup>

### Hybrid securities in outline

A hybrid security combines some of the features generally associated with share capital with some of those of debt capital.<sup>30</sup> It can also be described as a form of

<sup>23</sup> Law Commission, *Registration of Security Interests: Company Charges and Property Other Than Land* (Law Com CP No 164, 2002) paras 6.24–6.29.

<sup>24</sup> Competition Commission, 'The Supply of Banking Services by Clearing Banks to Small and Medium-sized Enterprises' (2002) paras 3.111–3.117.

<sup>25</sup> See RM Goode, *Commercial Law* (Penguin, 3rd edn, 2004); LS Sealy and RJA Hooley, *Commercial Law Text, Cases and Materials* (OUP, 3rd edn, 2003).

<sup>26</sup> Insolvency Act 1986, Sch 6 sets out the categories of preferential debt.

<sup>27</sup> *ibid* s 74(2)(f) (sums due to a member of the company). This section was considered in *Soden v British & Commonwealth Holdings plc* [1998] AC 298, CA and HL.

<sup>28</sup> G Moore, 'Europe's Second Cov-lite Loan' (2007) 26(5) *International Financial Law Review* 8.

<sup>29</sup> See further chs 11 and 15 below.

<sup>30</sup> R McCormick and H Creamer, *Hybrid Corporate Securities: International Legal Aspects* (Sweet & Maxwell, 1987).

mezzanine finance, occupying a mid-way position between debt and equity. A preference share is a form of hybrid security. Preference shares differ from ordinary shares in that they carry the right to a fixed annual dividend and/or to a return of a fixed principal amount. Preference shares normally carry limited voting rights. The fixed dividend and/or principal is payable in priority to the return on ordinary shares but (unless the terms on which the preference shares are issued otherwise provide) there is no right to participate over and above the fixed amount. The fixed return and the priority to ordinary shares are characteristics that resemble loan capital. Nevertheless, preference shares are still at law shares, although whether for accounting purposes they are equity instruments or financial liabilities depends on their specific terms. The legal constraints that flow from the maintenance of capital principle apply as much to preference shares as they do to ordinary shares: thus dividends on preference shares can be paid only from distributable profits and, accordingly, unlike interest, will not be paid if the company does not have these profits (but so long as the entitlement is cumulative it can be carried forward until such time as the company does have distributable profits); and holders of preference shares rank below creditors for the purposes of repayment.

A more sophisticated version of a preference share, is the convertible preference share which, in addition to the rights of a normal preference share, also entitles the holder at some point in the future to convert it into another security such as an ordinary share in the company or in its holding company. A convertible preference share combines the benefits of being preferential (in particular ranking ahead of ordinary shares for dividends and for repayment of capital) with the opportunity to share, via conversion, in capital growth, which is a key benefit associated with ordinary shares.

Debt capital can also be raised on terms that provide for the investor to be able to convert the debt into a share (of the borrower company or some other company) at some later date. This is described as convertible debt. Similar to a convertible debt security is a debt instrument with an attached warrant. The warrant gives the holder the option to subscribe shares. The debt-plus-warrant structure differs from convertible debt in that exercise of the warrant does not bring the debt instrument to an end, whereas the debt instrument disappears when a conversion right is exercised. The characteristic shared by convertible debt securities and warrants, and which makes them both hybrid securities, is that, unlike straight debt, they offer their holder the opportunity to participate in capital growth.

Another form of debt that is regarded as being hybrid is subordinated debt. Broadly speaking, when debt is subordinated its terms include provision for the principal amount of the loan (and sometimes interest as well) not to be repaid until some or all of the company's other debts have been paid in full. To compensate for the subordination, a company may have to pay a higher rate of interest than it would pay on its unsubordinated debt. To enhance the attractiveness of the investment opportunity for investors still further, it may also have to offer share options or conversion rights. Subordinated debt is similar to share capital in

that it ranks for payment behind other debts and, if share options or conversion rights are attached, it offers the opportunity to participate in capital growth. Yet it remains debt on which interest may be payable even if the company does not have distributable profits and, prior to conversion, it ranks higher on the repayment ladder than share capital.<sup>31</sup>

### Valuation of securities<sup>32</sup>

#### Shares

The value of a share ultimately comes down to what someone is willing to pay for it, and this can depend on precisely what it is that the purchaser seeks to acquire. Thus, a bidder who wants to take over a company may have to pay more for its shares than an investor who seeks to acquire a small parcel of its shares, the difference in price here being the premium that the bidder has to pay for control. Valuation is not an exact science but where shares are quoted, the starting point in any valuation process is to look at the price at which they are trading in the market. For some unquoted companies it may be possible to arrive at an estimate of the value of their shares based on empirical evidence of the market value of shares in analogous quoted companies. The market price of shares may then be compared with their value on the basis of other methods of valuation. This comparison may, in different contexts, assist professional investment analysts in arriving at their recommendations on whether to buy or sell securities, and enable bidders to determine the control premium they are prepared to pay. Other valuation techniques must necessarily be used to value the shares of unquoted companies where there are no appropriate quoted comparators.

The main methods of valuing shares otherwise than at the price at which they are trading in the market are set out below. All of these methods have limitations and some are more appropriate than others for particular purposes. Where they involve assumptions or projections, there is scope for different valuers to take different views. This means that the sensible course for, say, a potential bidder, is to

<sup>31</sup> *Collins v G Collins & Sons* (1984) 9 ACLR 58, NSW SC EqD illustrates this point. A corporate rescue scheme involving the subordination of certain debts was not approved by the court but, because of the technical differences between share capital and loan capital, it was prepared to sanction an alternative arrangement in which the relevant debts would be converted into preference shares. Query, however, whether it would be possible to structure subordinated debt which ranks behind preference shares. In principle, an arrangement whereby receipts in respect of subordinated debt are turned over to the preference shareholders should be possible but, depending on the structure used, this type of arrangement could raise financial assistance concerns or might be vulnerable as an indirect unlawful return of capital.

<sup>32</sup> HS Hounthaker and PJ Williamson, *The Economics of Financial Markets* (OUP, 1996) ch 6; RA Braley, SC Myers, and F Allen, *Principles of Corporate Finance* (McGraw-Hill, 8th edn, 2005) ch 4; SA Ross, RW Westerfield, and BD Jordan, *Corporate Finance: Core Principles and Applications* (McGraw-Hill, 2006) chs 4-7.

use a combination of valuation methodologies in order to derive a valuation range in respect of a target company.<sup>33</sup>

#### *Net asset value*

A valuation based on net asset value involves dividing the total market or book value of the company's net assets by the number of shares in issue. Where the book values of the company's assets are out of date, it may be necessary to conduct a revaluation exercise in order to bring these into line with market values. This method of valuation is the primary tool for valuing property companies. It is inappropriate where much of the value of the business is attributable to factors that do not appear in the balance sheet, such as the skills of the staff of an advertising or design company.

#### *Dividend valuation*

The principle underlying the dividend valuation method is that the value of a share lies in the flow of income that an investor can expect from it during its life, including any dividend paid on the liquidation of the company. Although the return to the holder of a share from time to time comes in the form of dividend plus the capital gain on the disposal of the share, the price that a purchaser is willing to pay for that share is based on expectation of future dividends, with the result that it is the value of the stream of dividends over the life of the share that represents its value. Dividend valuation methodology arrives at the present value of a share by looking at the expected flow of dividends during the life of the company and discounting future returns to reflect the time value of money and the risk that the expected cash flows may not in fact be forthcoming.

#### *Free cash flow valuation*

Instead of looking at just one component of the return to shareholders (ie dividends), the free cash flow valuation method proceeds on the basis that the company's entire free cash flow (ie its income remaining net of all operating costs and investment outlays) belongs to the shareholders. Discounted cash flow methodology involves discounting future cash flows at an appropriate discount rate and relies upon projections of future cash flows.

#### *Debt securities*

The value of a debt security lies in the present-day value of the stream of income payable in respect of the security. In the case of a simple debt security which has

<sup>33</sup> In a different context, note *Re Macro (Spwisch) Ltd* [1994] BCC 781, where the court employed both net-asset and dividend-yield methods of valuation as the basis for arriving at the price at which a minority holding in a private company should be bought out under (now) Companies Act 2006, s 994. Generally, on the valuation of shares in unquoted companies, see N Eastaway, H Booth, and K Eames, *Practical Share Valuation* (Butterworths, 4th edn, 1998).

a fixed interest rate and a fixed maturity date, its value is thus the discounted value of the interest that is payable during the life of the loan and of the principal amount that is repayable on maturity.

#### *Cost of capital*

The preceding discussion about valuation of shares and debt securities glossed over a fundamentally important point, namely, the appropriate discount rate to apply when determining the present value of expected future cash flows. The rate that is used must account for the time value of money and must reflect the risk that is inherent in any expectation of payments to be made in the future. A key element, therefore, is the valuation of risk. There are two forms of risk that are present in investing in corporate securities: risks relating to the particular companies whose securities are included in a portfolio (specific risks) and risks stemming from factors, such as the potential for changes in fiscal policy or interest rates, that are generally applicable (systematic risk). Portfolio theory dictates that an investor can eliminate specific risks by forming a diversified portfolio of investments in which risks attaching to particular securities are counterbalanced by the characteristics of other securities.<sup>34</sup> On this basis, it is only for systematic risk that investors can properly expect to receive compensation from the companies whose securities they hold. Accordingly, it is the valuation of systematic risk that is the focus of concern.

The Capital Asset Pricing Model (CAPM) is the most widely used technique for measuring systematic risk in equity investment and, hence, for estimating investors' required rate of return. In broad terms, the CAPM assesses the required rate of return on an equity investment by reference to the risk-free rate of return available to an investor, the premium required by investors to compensate them for the general systematic risk of investing in the equity market, and the undiversifiable systematic risk of a particular investment relative to the equity market. Although no investment is entirely risk-free, the rates of return on government securities (gilts) are the closest available comparator. The premium that investors require for holding a fully diversified portfolio of equity securities is determined by looking at the difference between historical gross returns on the equity market and on risk-free investments in gilts. The undiversifiable risk inherent in holding a particular share is known as its beta. Equity betas are calculated by reference to their historical returns and the corresponding returns on the market.

In theory, the CAPM can also be used to assess the required rate of return on debt securities but debt betas are not readily available. Instead, the rate of return required by investors in debt securities tends to be determined by reference to the rate of return on the existing debt securities of the company and of similar issuers. A similar process, involving examination of the company's borrowing history

<sup>34</sup> H Markowitz, 'Portfolio Selection' (1958) 7 *Journal of Finance* 77.



and comparison with analogous companies, may be used in determining the rate of return on debt finance provided by banks or other lenders.

The returns required by the providers of a company's share capital and debt constitute its cost of capital. The company's cost of capital is a driving factor in decisions on whether to invest in new projects because these will only be worthwhile investments where they are expected to generate returns at least equal to the company's cost of capital. Put another way, the company's cost of capital represents the cut-off rate for new projects. The average rate of a company's cost of capital is determined by the cost of its capital weighted by the proportion of funding obtained from each source (weighted average cost of capital, or 'WACC').

### Capital structure

In modern economics literature, the analysis of corporate capital structures usually starts with the Modigliani-Miller (MM) theorem as a benchmark.<sup>35</sup> The main elements of the original MM theory are that (a) the total value of a company is independent of its capital structure, and (b) the cost of a company's equity capital is a linear increasing function of its debt to equity ratio, keeping the overall cost of capital constant. In other words, increasing the amount of debt would lead to an offsetting increase in the cost of equity and vice versa.<sup>36</sup> This theorem as to the irrelevance of financial leverage was developed on the basis of certain restrictive assumptions, including the absence of taxes and insolvency and transaction costs, and the existence of perfect capital markets in which all investors have equal access to information. Much of the subsequent literature has re-evaluated MM with more realistic assumptions.<sup>37</sup> Once the assumptions on which the original theory was based are relaxed, in particular to take into account the fact that interest is tax deductible whereas dividends are not, it appears that it may be possible to add some debt to a company's capital structure without affecting the expected return to shareholders. Against this, the relaxation of the assumption of no insolvency costs points away from reliance on debt because, the greater the proportion of debt, the more likely it is that the company will default and enter

<sup>35</sup> F Modigliani and MH Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48 *American Economic Review* 433. For an appraisal of the theorem and some of the literature spawned by it, see MH Miller, 'The Modigliani-Miller Propositions After Thirty Years' (1988) 2 *Journal of Economic Perspectives* 99 and the other symposium papers published in that edition of the journal. Another overview that provides an introduction to decades of research on capital structure is SC Myers, 'Capital Structure' (2001) 15 *Journal of Economic Perspectives* 81. For a major review of the literature, see also M Harris and A Raviv, 'The Theory of Capital Structure' (1991) 46 *Journal of Finance* 297.

<sup>36</sup> RI Gilson and RR Kraakman, 'The Mechanisms of Market Efficiency: Twenty Years Later: The Hindersight Bias' (2003) 28 *Journal of Corporation Law* 715, 719.

<sup>37</sup> The original authors themselves relaxed some of the original assumptions in later papers: eg F Modigliani and MH Miller, 'Corporate Income Taxes and the Cost of Capital: a Correction' (1963) 53 *American Economic Review* 261.

into one of the corporate insolvency procedures within the framework of insolvency law. These procedures are costly to implement and, as the risk of insolvency grows with the addition of more and more debt to a company's capital structure, this can eventually outweigh the tax benefit of debt. The upshot of these competing considerations is that the addition of debt to a company's capital structure will be beneficial up to the point where the tax savings resulting from debt are eclipsed by the costs of financial distress. On that basis, the focus then shifts to the making of a trade-off between the benefits of debt and the expected costs of financial distress to determine the optimal long-term target capital structure. Subsidiary questions about the design of particular securities and about the public (capital markets) and private (banks) sources from which external finance may be available also assume considerable importance.

The trade-off theory of optimal capital structure implies that the correct mix of debt and equity for any particular company is dependent on a range of variables, including its age, its size, and the nature of its business and assets. Where companies are incorporated in another relevant variable because differences in applicable legal, tax, and institutional regimes can be expected to have some impact.<sup>38</sup> Gearing ratios do in fact vary across industries in ways that are broadly consistent with the theory: companies with steady cash flows or readily realizable assets, such as utility companies, tend to have higher gearing ratios;<sup>39</sup> and companies with relatively few current tangible assets but with considerable future growth prospects, such as exploration companies, tend to have lower gearing ratios, as do innovative technology companies where the reliability of profit growth is uncertain.<sup>40</sup> Some country-by-country differences can also be discerned.<sup>41</sup> At particular times—such as when a substantial new investment project is undertaken—there may temporarily be an abnormally high reliance on debt finance but some empirical evidence suggests that high gearing levels do not persist and that there is a strong reversion in leverage over the longer term as companies take steps to reduce their indebtedness.<sup>42</sup> However, evidence on the speed with which firms adjust towards target leverage does not all point in the same direction.<sup>43</sup>

<sup>38</sup> F Bancel and UR Mitroo, 'Cross-Country Determinants of Capital Structure Choice: A Survey of European Firms' (2004) 33(4) *Financial Management* 103.

<sup>39</sup> SC Myers, 'Capital Structure' (2001) 15 *Journal of Economic Perspectives* 81, 82–4.

<sup>40</sup> *Ibid.*

<sup>41</sup> F Degeorge and EG Maug, 'Corporate Finance in Europe: A Survey', ECGI—Finance Working Paper No 121/2006, (23 March 2006) available at SSRN <<http://ssrn.com/abstract=896518>>; Bancel and Mitroo (n 38 above) 103. Differences in accounting rules complicate the process of attempting country-by-country comparative studies of capital structure.

<sup>42</sup> C Mayer and O Sussman, 'A New Test of Capital Structure', CEPR Discussion Paper No 4239 (February 2004) available at SSRN <<http://ssrn.com/abstract=509022>>; P Bunn and G Young, 'Corporate Capital Structure in the United Kingdom: Determinants and Adjustment' (August 2004). Bank of England Working Paper No 226 (August 2004) available at SSRN <<http://ssrn.com/abstract=641281>>.

<sup>43</sup> R Huang and JR Ritter, 'Testing Theories of Capital Structure and Estimating the Speed of Adjustment' (26 July 2007) available at SSRN <<http://ssrn.com/abstract=938564>>. Forthcoming in *Journal of Financial and Quantitative Analysis*.



More generally, the trade-off theory does not fully explain real-life capital structures because in fact many profitable companies operate with much lower levels of tax-deductible debt than the theory would predict.<sup>44</sup>

A different point of view on corporate capital structures is provided by the 'pecking order' theory.<sup>45</sup> The basis of the pecking order theory is that asymmetric information between managers and investors gives rise to mispricing risks, which vary in scale depending on the information sensitivity of the financial instrument in question and which are therefore more severe in relation to equity than to debt. 'Good' managers will seek to minimize the risk of mispricing so as to maximize value and therefore will opt for forms of financing that are least affected by problems of asymmetric information. This implies a 'pecking order' capital structure in which internally-generated funds are preferred to external sources of finance and, as between external sources, debt is preferred to new equity.<sup>46</sup> Evidence of large projects being primarily financed externally from debt is consistent with the pecking order theory's identification of a preference for debt over equity but, at the same time, evidence that firms do not exhaust internal resources before turning to external sources to finance such projects is not consistent with the theory.<sup>47</sup> Nor does the pecking order theory explain evidence of reversions to initial capital structures in the longer term.<sup>48</sup>

While the trade-off and pecking order theories of capital structure both have some explanatory power, neither provides all the answers. The same can also be said of other theories on corporate capital structure that have developed alongside the two main theories or as refinements of them. One such theory, which is associated with the trade-off theory, is based on 'agency costs'. There are agency costs in corporate finance that flow from the potential conflicts of interest between debt and equity investors and also from the absence of a perfect alignment between managers' and investors' interests.<sup>49</sup> When considering from an agency cost perspective the trade-offs involved in using debt as a source of finance, it becomes necessary to add to the financial distress side of the equation the costs associated with risks that managers will prefer the interests of shareholders to those of creditors by transferring value from one group to the other or by engaging in excessive risk-taking. Agency cost analysis of the implications of conflicts of interest between debt and equity investors may be a factor that helps to explain why many companies operate with more conservative debt ratios than would be warranted by comparing the benefits of interest tax shields against the costs involved in

<sup>44</sup> SC Myers 'Capital Structure' (2001) 15 *Journal of Economic Perspectives* 81, 88–91.

<sup>45</sup> SC Myers, 'The Capital Structure Puzzle' (1984) *Journal of Finance* 575; SC Myers and NS Majluf, 'Corporate Financing and Investment Decisions When Firms Have Information Investors Do Not Have' (1984) 13 *Journal of Financial Economics* 187.

<sup>46</sup> Myers (n 44 above) 92–3.

<sup>47</sup> Mayer and Sussman (n 42 above).

<sup>48</sup> *ibid.*

<sup>49</sup> M Jensen and W Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

insolvency procedures.<sup>50</sup> On the other side of the equation, however, debt can be beneficial when it is examined through the lens of the misalignment between managers' and investors' interests because it acts as a discipline on management by forcing firms to commit cash to debt interest payments; as such, it reduces opportunities for managers to use the free cash flow to engage in 'empire building' for their own reputational advantage or in other activities that benefit themselves rather than investors.<sup>51</sup> From this perspective, some of the explanation for why managers do not exploit the tax advantages of debt as fully as the trade-off theory would imply may lie in their reluctance to submit to the disciplining effect of adding more debt to the capital structure.<sup>52</sup>

Yet another line of analysis suggests a 'market timing' theory of capital structure, which is to the effect that firms' capital structures can be understood as the cumulative result of efforts to time the equity market—ie to issue shares when market prices are high and to repurchase them when market values are low.<sup>53</sup> The market timing theory posits that financing decisions that depend on the time-varying relative costs of equity and debt have long-lasting effects on capital structure because the observed capital structure at any given date is the outcome of prior period-by-period securities issuance decisions.<sup>54</sup>

Despite considerable advances made by a rich body of literature, it is widely acknowledged that corporate capital structure decisions involve complex, multi-dimensional problems that are not yet fully understood and explained. Thus it has been said that: 'In any case, understanding the determinants of the evolution of capital structure is arguably the most important unresolved question in corporate finance, and only time and additional empirical work will tell where the answer lies.'<sup>55</sup> According to an empirical study involving a comprehensive survey of corporate financing decision-making in UK listed companies, published in 2006, firms were heterogeneous in their capital structure policies: about half of the firms sought to maintain a target debt level, consistent with trade-off theory, but 60 per cent claimed to follow a financing hierarchy, consistent with pecking order theory.<sup>56</sup> These two theories were not viewed by respondents as either mutually exclusive or exhaustive.

<sup>50</sup> Myers (n 44 above) 98.

<sup>51</sup> MC Jensen, 'Agency Costs of Free Cash Flow, Corporate Finance and Takeovers' (1986) 76(2) *American Economic Review* 323.

<sup>52</sup> Myers (n 44 above) 99.

<sup>53</sup> M Baker and J Wurgler, 'Market Timing and Capital Structure' (2002) 57 *Journal of Finance* 1.

<sup>54</sup> R Huang and JR Ritter, 'Testing Theories of Capital Structure and Estimating the Speed of Adjustment' (26 July 2007) available at SSRN <<http://ssrn.com/abstract=938564>>.

<sup>55</sup> *ibid.*

<sup>56</sup> V Beattie, A Goodacre, and SJ Thomson, 'Corporate Financing Decisions: UK Survey Evidence' (2006) 33(9) & (10) *Journal of Business Finance & Accounting* 1402. See also F Degeorge and EG Maug, 'Corporate Finance in Europe: A Survey', ECGI—Finance Working Paper No 121/2006 (23 March 2006) available at SSRN: <<http://ssrn.com/abstract=896518>>; F Bancel and

### Sources of corporate finance in the UK

Smaller companies are heavily dependent on internal sources of finance and bank finance is their main source of external finance.<sup>57</sup> The external sources of finance available to small and medium-sized businesses is an issue that has been the focus of concern in a number of official reports stretching back many years.<sup>58</sup> The providers of debt finance to smaller firms currently operate in a quite concentrated industry, which was last investigated by the UK Competition Commission in 2002.<sup>59</sup> The Commission found that the cost and availability of lending in general were not a problem but it did identify factors indicating a market lacking effective competition among suppliers. As a consequence of that investigation, the clearing banks were required to give certain undertakings that were intended to remedy excessive profits and prices and to encourage price competition. However, in 2007, after a review by the Office of Fair Trading, some of these undertakings were relaxed in response to identified changes in the market that had improved the level of competition.<sup>60</sup>

External equity plays only a small role in the financing of small businesses generally.<sup>61</sup> Whether, or to what extent, the explanation for this lies in an 'equity gap' market failure—i.e. lack of access to an appropriate level of equity financing—as opposed to reluctance on the part of the founders of such businesses to give up a share of ownership, is not entirely clear but the possibility of there being a market failure in the equity financing of technology-based small and medium-sized enterprises (SMEs) has been recognized.<sup>62</sup> In 2005, the government conducted 'A Mapping Study of Venture Capital Provision to SMEs in England', in which it sought to map out the provision of venture capital to SMEs in England, 'venture capital' being defined in this study to mean not only investment provided in the earlier stages of a company's life, and particularly in technology-oriented

UR Mirro, 'Cross-Country Determinants of Capital Structure Choice: A Survey of European Firms' (2004) 33(4) *Financial Management* 103.

<sup>57</sup> M Lund and J Wright, 'The Financing of Small Firms in the United Kingdom' (May 1999) *Bank of England Quarterly Bulletin* 195.

<sup>58</sup> *Report of the Committee to Review the Functioning of Financing Institutions* (Cmd 7937, 1980) which, in app 2, sets out the conclusion and summary of recommendations from the Committee's interim report on the financing of small firms (Cmd 7503, 1979). Earlier reports on the financing of British industry also noted the particular difficulties faced by small firms: *Report of the Committee on Finance and Industry* (Cmd 3897, 1931) (Macmillan Report); *Report of the Committee on the Working of the Monetary System* (Cmd 827, 1959) (Radcliffe Report); *Report of the Committee of Inquiry on Small Firms* (Cmd 4811, 1971) (Bolton Report). A general review of the financial structure of small and medium-sized enterprises (SMEs) is provided by A Hughes, 'Finance for SMEs: A UK Perspective' (1997) 9 *Small Business Economics* 151.

<sup>59</sup> Competition Commission, 'The Supply of Banking Services by Clearing Banks to Small and Medium-sized Enterprises' (2002).

<sup>60</sup> OFT, 'SME Banking' (Report, August 2007).

<sup>61</sup> Lund and Wright (n 57 above) 199.

<sup>62</sup> *Ibid* 200–1.

sectors (as the term is now widely understood), but also all forms of private equity provision to SMEs, regardless of stage or sector. The survey found that there had been dramatic growth in the previous ten years in the levels of venture capital and private equity activity in the UK and elsewhere in continental Europe but concluded that it remained the case that there were still sectors, stages, and regions of the economy that did not have access to an adequate supply of venture finance.<sup>63</sup> External equity finance is more important for technology-based small firms than for the sector generally.<sup>64</sup>

Survey data suggests that access to debt finance is not a major problem for smaller quoted companies in aggregate.<sup>65</sup> Banks are the main source; smaller quoted companies do not generally have access to bond markets because of their size.<sup>66</sup> Although there are concerns that access to equity financing could be more difficult because of secondary market illiquidity in the shares of smaller companies, lack of interest in such shares from the investment management and investment analyst communities, and owners' unwillingness to dilute equity stakes, recent data does not support the view that there are major barriers to raising equity finance for the broad majority of smaller quoted companies.

Large, profitable companies have the biggest range of available financing options. The trade-off theory may suggest a positive relationship between profitability and gearing because there is a low risk of financial distress and the tax benefits of debt should increase as profits rise.<sup>67</sup> The agency costs theory would also appear to point in the same direction because of the disciplining effect of debt servicing commitments and of restrictive covenants.<sup>68</sup> On the other hand, the pecking order theory would suggest a negative relationship because highly profitable companies will have less need than other companies for any type of external finance.<sup>69</sup> Survey data indicates a sharp rise in UK corporate gearing between 1999 and 2002, with rises in gearing being concentrated among the largest and most profitable companies.<sup>70</sup>

<sup>63</sup> DTI, 'A Mapping Study of Venture Capital Provision to SMEs in England' (DTI, Small Business Service, October 2005) para 2.1.

<sup>64</sup> P Brierley and P Bunn, 'The Determinants of UK Corporate Capital Gearing' (Autumn 2005) *Bank of England Quarterly Bulletin* 356, 363; P Brierley, 'The Financing of Technology-based Small Firms: A Review of the Litterature' (Spring 2001) *Bank of England Quarterly Bulletin* 201.

<sup>65</sup> P Brierley and M Young, 'The Financing of Smaller Quoted Companies: A Survey' (Summer 2004) *Bank of England Quarterly Bulletin* 160. This survey defines SOCs to include non-financial companies with a full listing on the London Stock Exchange with a market capitalization below that of companies in the FTSE 350 index and those companies quoted on AIM.

<sup>66</sup> A Kearns and JE Young, 'Provision of Finance to Smaller Quoted Companies: Some Evidence from Survey Responses and Liaison Meetings' (Spring 2002) *Bank of England Quarterly Bulletin* 26.

<sup>67</sup> P Brierley and P Bunn, 'The Determinants of UK Corporate Capital Gearing' (Autumn 2005) *Bank of England Quarterly Bulletin* 356, 362.

<sup>68</sup> *Ibid*.

<sup>69</sup> *Ibid*. See also RG Rajan and L Zingales, 'What Do We Know About Capital Structure: Some Evidence From International Data (1995) 50(5) *Journal of Finance* 1421.

<sup>70</sup> Brierley and Bunn (n 67 above) 362.

### Securities markets

In broad terms, the securities markets comprise domestic and international markets for the issuance and trading of equity and debt securities and related financial instruments. Issuance is 'primary' market activity and trading is 'secondary' market activity. Secondary market activity is largely outside the scope of this book.

The Bank for International Settlements (BIS) publishes quarterly statistics on securities markets, broken down into three segments: international debt securities; international equities; and domestic debt securities. The BIS definition of international securities (as opposed to domestic securities) is based on three major characteristics of the securities: the location of the transaction, the currency of issuance, and the residence of the issuer. International issues comprise all foreign currency issues by residents and non-residents in a given country and all domestic currency issues launched in the domestic market by non-residents. In addition, domestic currency issues launched in the domestic market by residents are also considered as international issues if they are specifically targeted at non-resident investors.<sup>71</sup> Domestic debt securities are defined as those that have been issued by residents in domestic currency (with a few exceptions) and targeted at resident investors.<sup>72</sup> Tables 3.3 and 3.4 below, are taken from the BIS statistics; they provide an idea of the size and level of activity in the debt and equity international securities markets. According to the BIS statistics, amounts outstanding on domestic debt securities issued by UK resident corporate issuers at September 2006 fell just short of US\$23 billion.<sup>73</sup>

It is not essential for a company that is in search of capital from the domestic or international securities markets to do so via a formally organized stock exchange or other trading facility. However, admission of securities to trading on an exchange or other trading system may offer significant benefits, including access to bigger pools of capital, better liquidity, and an enhanced corporate profile.

The Main Market of the London Stock Exchange is the UK's most prestigious organized securities market.<sup>74</sup> It is open to UK companies and also to companies from other countries. Companies can list different types of shares and debt securities on the Main Market. Other financial instruments can also be listed, including securitized derivatives and securitized commodities. The market now has a

<sup>71</sup> BIS, 'Guide to the International Financial Statistics', (BIS Papers No 14 February 2003) section III, para 1.1.

<sup>72</sup> *Ibid.*, section III, para 3.1.

<sup>73</sup> BIS, *Quarterly Review* (March 2007), Table 16B (Domestic debt securities).

<sup>74</sup> This section on the Main Market is based on information on the London Stock Exchange's website, in particular its publication 'A Guide to the Main Market', see <<http://www.londonstockexchange.com/en-gb/>> (accessed December 2007).

**Table 3.3.** International debt securities—corporate issuers

Countries	By nationality of issuer									
	Amounts outstanding				Net issues					
	Dec 2004	Dec 2005	Sep 2006	Dec 2006	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006
<b>All countries</b>	<b>1,608.9</b>	<b>1,544.9</b>	<b>1,770.8</b>	<b>1,887.1</b>	<b>52.8</b>	<b>248.2</b>	<b>68.9</b>	<b>57.1</b>	<b>42.3</b>	<b>79.9</b>
<b>Developed countries</b>	<b>1,457.5</b>	<b>1,380.8</b>	<b>1,590.2</b>	<b>1,692.4</b>	<b>38.4</b>	<b>219.0</b>	<b>64.0</b>	<b>52.9</b>	<b>35.4</b>	<b>66.7</b>
Australia	17.2	15.4	16.3	17.0	-0.8	0.8	-0.1	0.4	0.2	0.3
Austria	11.4	15.6	17.5	19.4	5.9	2.2	0.3	0.7	-0.1	1.3
Belgium	11.4	8.9	9.8	13.0	-1.2	3.1	0.8	0.3	-0.7	2.8
Canada	100.1	99.3	98.0	101.4	-0.3	1.5	-1.1	-3.4	2.5	3.4
Denmark	16.1	16.6	16.7	16.6	2.7	-1.6	-0.0	-0.4	-0.6	-0.7
Finland	17.1	13.6	16.4	15.9	-1.7	1.0	-0.2	2.1	0.1	-1.0
France	271.8	246.3	266.8	280.1	8.9	7.1	-3.6	8.4	-1.0	3.3
Germany	95.3	89.1	110.3	110.7	5.8	11.2	1.8	14.0	-0.9	-3.7
Greece	9.5	8.9	10.3	14.6	0.6	4.7	—	0.8	—	3.9
Iceland	1.4	1.3	1.6	1.8	-0.0	0.4	0.1	-0.0	0.3	0.1
Ireland	9.1	8.4	10.2	10.0	0.2	1.0	-0.1	-0.1	1.6	-0.4
Italy	66.2	50.9	55.8	59.9	-7.2	3.3	-0.2	-0.2	1.7	2.0
Japan	63.3	58.9	59.1	59.8	2.1	0.3	0.6	0.6	-1.7	0.8
Luxembourg	4.4	3.6	3.7	3.9	-0.5	0.0	0.8	-0.7	-0.1	0.0
Netherlands	59.9	52.2	55.7	61.0	-1.2	3.9	2.0	-1.3	-0.3	3.5
New Zealand	2.6	2.4	2.7	2.8	-0.1	0.3	-0.2	0.4	0.0	0.1
Norway	20.0	18.5	20.0	20.4	-0.2	1.0	-0.4	-0.3	1.7	-0.1
Portugal	5.3	5.5	5.5	9.0	1.0	2.8	-0.6	0.4	-0.2	3.2
Spain	27.6	24.6	40.0	41.7	-0.3	14.2	7.1	4.2	2.5	0.4
Sweden	18.3	18.5	16.7	18.0	2.4	-2.2	0.3	-3.1	-0.1	0.7
Switzerland	8.6	8.2	8.8	9.0	0.3	0.4	-0.3	0.0	0.6	0.0
United Kingdom	218.2	202.8	248.3	259.4	4.9	34.6	16.6	1.3	14.2	2.4
United States	402.5	411.4	499.9	547.0	16.9	129.3	40.4	28.8	15.5	44.5

*Continued*

Table 3.3. (Continued)

By nationality of issuer										
In billions of US dollars										
Countries	Amounts outstanding				Net issues					
	Dec 2004	Dec 2005	Sep 2006	Dec 2006	2005	2006	Q1 2006	Q2 2006	Q3 2006	Q4 2006
<b>Offshore centres</b>	<b>26.9</b>	<b>27.3</b>	<b>28.6</b>	<b>29.0</b>	<b>0.8</b>	<b>1.3</b>	<b>0.2</b>	<b>0.8</b>	<b>0.0</b>	<b>0.3</b>
Aruba	—	—	—	—	—	—	—	—	—	—
Bahamas	0.9	0.9	0.7	0.7	—	-0.1	—	-0.1	—	—
Bermuda	0.2	0.6	0.6	0.5	0.4	-0.1	—	—	—	-0.1
Cayman Islands	—	—	—	—	—	—	—	—	—	—
Hong Kong SAR	15.5	15.5	15.0	15.2	0.1	-0.4	0.2	-0.5	-0.2	0.1
Lebanon	0.0	0.0	—	—	—	-0.0	—	—	-0.0	—
Netherlands Antilles	—	—	—	—	—	—	—	—	—	—
Panama	0.2	0.3	0.3	0.3	0.2	—	—	—	—	—
Singapore	10.0	10.0	11.8	12.2	0.1	2.0	-0.0	1.5	0.3	0.3
West Indies UK	0.1	0.1	0.1	0.1	0.0	0.0	—	—	—	0.0
<b>Developing countries</b>	<b>124.5</b>	<b>136.7</b>	<b>152.1</b>	<b>165.7</b>	<b>13.7</b>	<b>27.9</b>	<b>4.8</b>	<b>3.3</b>	<b>6.9</b>	<b>12.9</b>
<b>Africa &amp; Middle East</b>	<b>11.6</b>	<b>13.2</b>	<b>19.0</b>	<b>26.4</b>	<b>1.8</b>	<b>13.1</b>	<b>2.4</b>	<b>1.2</b>	<b>2.4</b>	<b>7.1</b>
Israel	5.6	4.8	6.3	6.0	-0.8	1.1	1.4	0.1	—	-0.4
Qatar	1.6	3.8	5.9	5.9	2.2	2.1	-0.0	0.7	1.5	—
South Africa	3.9	4.1	5.1	5.6	0.4	1.4	1.1	0.2	-0.1	0.2
Tunisia	—	—	—	—	—	—	—	—	—	—
United Arab Emirates	0.5	0.5	1.3	8.3	—	7.7	—	0.3	0.5	7.0
<b>Asia &amp; Pacific</b>	<b>62.7</b>	<b>68.3</b>	<b>74.1</b>	<b>75.8</b>	<b>6.1</b>	<b>7.3</b>	<b>0.5</b>	<b>1.6</b>	<b>3.5</b>	<b>1.6</b>
China	1.5	1.0	1.1	1.1	-0.5	0.2	—	0.2	-0.1	0.1
India	4.1	6.7	12.0	12.7	2.5	6.0	2.5	2.2	0.5	0.7
Indonesia	0.1	0.3	0.2	0.2	0.2	-0.1	—	-0.1	—	—
Malaysia	7.3	6.4	6.8	6.0	-0.8	-0.5	-0.1	-0.1	0.5	-0.8
Philippines	4.7	5.0	4.5	4.8	0.3	-0.1	0.0	-0.2	-0.2	0.3
South Korea	22.7	25.5	27.9	28.2	3.2	2.5	0.1	0.6	1.5	0.2
Taiwan, China	19.5	19.3	16.6	17.1	-0.2	-2.2	-2.0	-0.7	-0.0	0.5
Thailand	2.4	3.8	3.5	3.6	1.4	-0.2	-0.0	-0.3	0.0	0.1
<b>Europe</b>	<b>12.2</b>	<b>13.2</b>	<b>14.6</b>	<b>16.4</b>	<b>1.3</b>	<b>2.8</b>	<b>0.3</b>	<b>0.4</b>	<b>0.5</b>	<b>1.6</b>
Croatia	0.4	0.3	0.0	0.2	-0.1	-0.1	—	—	-0.3	0.2
Cyprus	0.1	0.1	0.1	0.1	—	—	—	—	—	—
Hungary	—	0.9	1.2	1.3	0.9	0.3	0.3	—	—	—
Poland	0.4	0.3	0.3	0.4	—	—	—	—	—	—
Russia	7.7	8.5	9.2	10.1	0.8	1.7	0.1	0.4	0.2	0.9
Slovakia	0.7	0.6	0.7	0.5	—	-0.2	—	—	—	-0.2
Turkey	0.4	—	0.3	0.3	-0.4	0.3	—	—	0.3	0.1
<b>Latin America &amp; Caribbean</b>	<b>37.9</b>	<b>42.1</b>	<b>44.4</b>	<b>47.1</b>	<b>4.5</b>	<b>4.8</b>	<b>1.5</b>	<b>0.1</b>	<b>0.5</b>	<b>2.6</b>
Argentina	4.3	3.8	3.7	3.9	-0.5	0.1	—	-0.2	0.1	0.2
Brazil	10.7	10.8	13.4	13.3	0.2	2.4	1.3	0.5	0.7	-0.1
Chile	6.8	7.2	6.4	6.9	0.5	-0.4	-0.7	0.2	-0.4	0.5
Colombia	0.9	0.9	1.0	1.0	-0.0	0.1	—	0.1	—	—
Mexico	14.6	18.4	18.2	19.8	3.9	1.4	0.4	-0.6	-0.0	1.6
Peru	—	—	—	—	—	—	—	—	—	—
Uruguay	—	—	—	—	—	—	—	—	—	—
Venezuela	0.3	0.3	0.3	0.3	—	0.1	0.1	0.0	0.0	0.0

Source: Bank for International settlements, *Quarterly Review* (March 2007), Table 12C. Reproduced with permission of the BIS <<http://www.bis.org>>.

Table 3.4. Announced international equity issues

Countries	By nationality of issuer											
	In billions of US dollars											
	2004	2005	2006	Q4 2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
<b>All countries</b>	<b>219.4</b>	<b>307.8</b>	<b>377.9</b>	<b>70.9</b>	<b>66.0</b>	<b>60.9</b>	<b>73.8</b>	<b>107.1</b>	<b>71.4</b>	<b>102.6</b>	<b>70.9</b>	<b>133.0</b>
<b>Developed countries</b>	<b>160.8</b>	<b>212.4</b>	<b>227.6</b>	<b>50.5</b>	<b>50.8</b>	<b>39.8</b>	<b>49.4</b>	<b>72.4</b>	<b>46.2</b>	<b>65.8</b>	<b>41.0</b>	<b>74.5</b>
Australia	7.1	7.5	10.0	1.6	1.4	0.9	1.9	3.4	1.7	1.8	0.9	5.7
Austria	5.0	3.9	12.1	3.0	0.2	2.1	0.1	1.5	4.2	5.6	0.1	2.2
Belgium	5.0	2.7	2.9	1.2	0.4	1.1	—	1.2	0.7	0.0	1.6	0.6
Canada	10.8	12.1	5.9	5.5	4.9	2.7	2.4	2.1	1.8	1.6	0.2	2.3
Denmark	3.7	0.7	3.4	1.0	—	0.1	0.1	0.5	0.5	0.0	0.1	2.8
Finland	1.6	4.4	1.9	0.9	1.4	2.0	0.4	0.7	0.7	0.1	—	1.1
France	27.5	35.6	34.5	7.7	6.2	6.4	7.5	15.5	8.9	10.7	2.7	12.1
Germany	16.8	30.1	25.4	7.6	6.3	6.2	9.2	8.4	5.2	5.6	8.6	6.0
Greece	1.5	5.1	3.7	0.7	0.7	0.6	2.8	1.0	0.8	1.3	0.1	1.5
Iceland	1.5	0.7	1.2	0.9	—	—	—	0.7	0.3	—	—	0.9
Ireland	1.7	1.4	2.3	0.1	0.2	0.3	0.6	0.2	0.6	0.1	0.9	0.7
Italy	16.2	19.4	11.3	7.5	3.2	4.2	5.6	6.4	2.3	5.1	0.8	3.0
Japan	8.0	9.9	11.8	2.0	3.0	0.2	1.8	4.9	4.0	0.1	3.1	4.6
Luxembourg	3.0	0.9	0.4	0.9	—	—	0.9	—	0.4	—	—	—
Netherlands	6.8	13.9	9.6	2.1	5.6	1.8	2.7	3.7	0.6	4.9	2.0	2.1
New Zealand	0.2	0.2	—	0.0	0.1	—	0.0	0.0	—	—	—	—
Norway	3.7	5.4	7.1	0.2	2.9	0.7	0.4	1.4	2.3	3.0	0.9	0.9
Portugal	1.3	1.4	1.6	0.8	0.1	—	1.3	—	—	0.7	—	0.9
Spain	6.5	8.1	8.0	1.1	2.0	0.6	4.9	0.5	—	1.5	1.3	5.1
Sweden	5.4	2.6	3.8	2.1	0.8	0.5	0.4	1.0	0.7	1.2	0.3	1.5
Switzerland	4.2	6.0	14.0	1.0	0.2	0.6	1.5	3.8	1.3	6.0	0.5	6.2
United Kingdom	21.4	34.6	41.9	2.3	9.8	7.2	3.8	13.7	7.8	8.4	14.1	11.6
United States	1.7	5.9	14.7	0.4	1.3	1.7	1.0	1.9	1.6	7.9	2.6	2.6
<b>Offshore centres</b>	<b>12.4</b>	<b>18.1</b>	<b>25.1</b>	<b>5.7</b>	<b>2.7</b>	<b>3.6</b>	<b>2.3</b>	<b>9.4</b>	<b>4.0</b>	<b>6.4</b>	<b>5.3</b>	<b>9.3</b>
Bahamas	—	—	0.1	—	—	—	—	—	—	—	—	0.1
Bahrain	—	0.1	0.4	—	—	—	—	0.1	—	—	—	0.4
Bermuda	2.2	3.9	2.0	0.7	0.6	0.4	0.2	2.7	0.6	0.7	0.8	0.0
Cayman Islands	—	0.0	1.2	—	—	0.0	—	—	—	0.0	—	1.2
Hong Kong SAR	7.4	7.5	16.0	3.3	1.5	0.9	1.2	4.0	1.3	4.3	3.3	7.2
Lebanon	—	0.8	0.2	—	—	—	—	0.8	0.2	—	—	—
Panama	—	0.4	0.2	—	—	—	—	0.4	—	0.2	—	—
Singapore	2.8	3.6	4.4	1.7	0.6	0.5	1.0	1.4	1.9	0.9	1.3	0.3
West Indies	—	—	0.1	—	—	—	—	—	—	—	—	0.1
UK	—	—	—	—	—	—	—	—	—	—	—	—
<b>Developing countries</b>	<b>46.2</b>	<b>77.3</b>	<b>125.2</b>	<b>14.7</b>	<b>12.5</b>	<b>17.5</b>	<b>22.1</b>	<b>25.2</b>	<b>21.1</b>	<b>30.3</b>	<b>24.6</b>	<b>49.3</b>
<b>Africa &amp; Middle East</b>	<b>4.8</b>	<b>5.0</b>	<b>5.0</b>	<b>1.3</b>	<b>1.2</b>	<b>0.8</b>	<b>0.7</b>	<b>2.3</b>	<b>3.0</b>	<b>0.7</b>	<b>0.3</b>	<b>1.1</b>
Egypt	0.1	0.7	0.7	0.1	—	0.2	—	0.5	0.3	0.4	—	—
Israel	1.5	2.0	0.6	0.2	1.1	0.2	0.3	0.4	0.2	0.1	—	0.2
Jordan	—	0.3	—	—	—	—	—	0.3	—	—	—	—
South Africa	1.9	1.0	2.4	—	—	0.3	0.3	0.5	2.1	—	0.1	0.1
United Arab Emirates	0.2	0.8	0.8	—	0.2	—	—	0.7	—	0.1	0.0	0.7
<b>Asia &amp; Pacific</b>	<b>33.6</b>	<b>56.9</b>	<b>82.5</b>	<b>8.7</b>	<b>8.6</b>	<b>13.8</b>	<b>15.4</b>	<b>19.1</b>	<b>11.1</b>	<b>24.0</b>	<b>11.0</b>	<b>36.4</b>
China	18.1	26.9	50.3	4.9	2.2	8.0	4.3	12.4	3.1	16.8	5.3	25.1
Georgia	—	—	0.2	—	—	—	—	—	—	—	—	0.2
India	4.6	8.6	10.1	0.7	3.1	2.5	1.1	1.9	2.3	2.0	0.7	5.2

Continued

Table 3.4. (Continued)

Countries	By nationality of issuer In billions of US dollars											
	2004	2005	2006	Q4 2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Indonesia	0.8	1.0	0.8	0.2	0.2	0.1	0.8	—	—	0.1	0.2	0.5
Kazakhstan	—	0.2	4.1	—	—	—	—	0.2	—	—	2.4	1.7
Malaysia	0.9	1.4	0.8	0.2	0.2	0.2	0.4	0.6	0.0	—	0.3	0.4
Pakistan	—	—	0.9	—	—	—	—	—	—	—	—	0.9
Philippines	0.1	0.9	1.5	0.1	0.9	—	—	—	0.5	0.2	0.4	0.4
South Korea	4.6	9.7	7.5	0.5	0.5	1.6	3.8	3.7	4.1	2.7	0.2	0.5
Taiwan,	3.4	7.9	3.8	1.3	1.4	1.4	4.8	0.2	0.8	0.8	1.4	0.8
China	—	—	—	—	—	—	—	—	—	—	—	—
Thailand	1.1	0.3	2.1	0.9	0.1	0.0	0.2	0.0	0.1	1.3	0.1	0.6
<b>Europe</b>	<b>5.4</b>	<b>10.1</b>	<b>23.9</b>	<b>3.9</b>	<b>2.1</b>	<b>2.1</b>	<b>3.3</b>	<b>2.6</b>	<b>2.8</b>	<b>2.3</b>	<b>10.2</b>	<b>8.6</b>
Croatia	—	—	0.2	—	—	—	—	—	—	—	—	0.2
Cyprus	—	0.3	1.2	—	—	—	—	0.3	0.2	—	—	0.8
Czech	0.2	0.3	0.3	—	—	0.1	0.2	—	—	—	—	0.3
Republic	—	—	—	—	—	—	—	—	—	—	—	—
Hungary	0.8	0.0	—	0.5	—	—	0.0	—	—	—	—	—
Poland	0.9	1.0	0.8	0.7	0.1	0.4	0.4	0.1	0.2	0.0	0.1	0.5
Romania	—	—	0.2	—	—	—	—	—	—	0.0	—	0.2
Russia	2.5	6.5	19.6	2.2	1.7	1.2	2.6	0.9	2.3	1.5	10.0	5.9
Turkey	1.0	1.5	1.5	0.4	0.2	0.3	0.1	0.9	0.1	0.7	—	0.7
<b>Latin</b>	<b>2.4</b>	<b>5.3</b>	<b>13.8</b>	<b>0.9</b>	<b>0.5</b>	<b>0.9</b>	<b>2.7</b>	<b>1.3</b>	<b>4.3</b>	<b>3.3</b>	<b>3.1</b>	<b>3.2</b>
<b>America &amp;</b>												
<b>Caribbean</b>												
Argentina	—	—	0.9	—	—	—	—	—	0.9	—	—	—
Brazil	2.0	2.8	10.9	0.9	0.5	0.5	1.2	0.6	2.4	3.1	2.9	2.4
Chile	0.3	0.6	—	—	—	—	0.2	0.4	—	—	—	—
Mexico	0.2	2.0	1.5	—	0.0	0.3	1.3	0.3	1.0	0.1	0.2	0.2
Peru	—	—	0.6	—	—	—	—	—	—	—	—	0.6

Source: Bank for International Settlements, *Quarterly Review* (March 2007), Table U8. Reproduced with permission of the BIS at <http://www.bis.org>.

combined capitalization of over £4.3 trillion. In 2006, there were 83 new issues on the Main Market, raising over £18.8 billion and 712 further issues raising more than £14.5 billion. The Alternative Investment Market (AIM) is the London Stock Exchange's second-tier market. It describes itself as 'the world's leading market for smaller, growing companies from all over the world'.<sup>75</sup> Since its establishment in 1995, AIM has attracted over 2,100 companies, which between them have raised over £2.2 billion. AIM has a strong international focus. Compared to the Main Market, AIM has less stringent admission criteria and less wide-ranging continuing obligations. The London Stock Exchange also operates the Professional Securities Market (PSM), which is a market that enables domestic and overseas companies to raise capital through the issue of specialist securities, such as debt, convertibles, and depositary receipts, to professional or institutional investors.<sup>76</sup> The regulatory requirements governing the PSM are different from those for the Main Market and AIM because they are tailored for a specialist, professionals-only market segment.

The London Stock Exchange does not have a complete monopoly on securities market infrastructure provision in the UK. Another provider is the PLUS Markets Group, which provides primary and secondary equity market services.<sup>77</sup> The 'PLUS-quoted' primary market competes with AIM by specializing in smaller and mid-cap companies, domestic and international. As of mid-2007, it quoted around 180 companies with a combined market capitalization of over £2.4 billion. The 'PLUS-listed' market is a new market, launched in July 2007, that is intended to compete with the Main Market of the London Stock Exchange and is thus aimed at issuers of securities seeking a full listing.

### Efficient capital markets

Efficient capital markets theory underpins the conventional understanding of the pricing of securities in financial markets.<sup>78</sup> In general terms, the theory is concerned with whether prices at any point in time 'fully reflect' available information.<sup>79</sup> Ever since a classic review published in 1970, it has been usual to distinguish between three degrees of efficiency: weak-form efficiency, semi-strong-form efficiency, and strong-form efficiency.<sup>80</sup> In a weak-form efficient

<sup>75</sup> This section on AIM is based on information on the London Stock Exchange website, in particular its publication, 'AIM—the most successful growth market in the world', from which the quotation is taken.

<sup>76</sup> This section on the PSM is based on information on the London Stock Exchange's website, plus [www.plusmarketsgroup.com](http://www.plusmarketsgroup.com) (accessed December 2007).

<sup>77</sup> Information on the PLUS Markets is taken from the PLUS Group website <<http://www.plusmarketsgroup.com>> (accessed December 2007).

<sup>78</sup> For an overview of the literature on this topic, see HS Houthakker and PJ Williamson, *The Economics of Financial Markets* (OUP, 1996) 130–40.

<sup>79</sup> E.F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383.

<sup>80</sup> *Ibid.*

market, the current prices of securities reflect all relevant historical information. A semi-strong efficient capital market is one where prices adjust rapidly in response to information as soon as it becomes available. A strong-form efficient capital market is one where the prices reflect all relevant information, including information that has not yet been made public. Empirical research supports weak-form efficiency and semi-strong efficiency as explanations of how securities markets actually work in major jurisdictions, with the semi-strong version being the one that is most favoured.<sup>81</sup> That markets do not normally conform to the strong-form efficiency hypothesis is demonstrated by the (illegal) profits that can be made by insider trading: the opportunity for profit exists because market prices have not yet absorbed the information that has not been made public or, to put it another way, because the market is not conforming to the model of strong-form efficiency.

The efficient capital market hypothesis provides the intellectual context for disclosure-oriented securities regulation.<sup>82</sup> It has been said that: 'Almost all issues are discussed against the background of market efficiency: whether issuers should be required to make duplicative disclosures; whether company insiders should be permitted to speak privately with institutional investors and analysts; and how damages can be inferred from stock price movements. Market efficiency and the mechanisms of market efficiency factor into all of these policy debates—and quite appropriately.'<sup>83</sup> Yet the hegemony of the efficient capital market hypothesis has not gone completely unquestioned. A distinction is now often drawn between *informational* efficiency and *fundamental* efficiency, by which is meant that prices represents the best current estimate of the present value of the future cash flows associated with a security. If prices in an informationally efficient market are inaccurate in a fundamental sense, this implies a potential problem with regard to allocative efficiency, meaning that scarce resources may fail to be allocated to their most productive use.<sup>84</sup> The trend for economists to incorporate behavioural sciences into their work has also cast a deep shadow over the efficient capital markets hypothesis because that hypothesis does not capture socio-psychological factors that may lead investors to engage in irrational trading activities that affect share prices.<sup>85</sup> Although supporters of the efficient capital markets

<sup>81</sup> EF Fama, 'Efficient Capital Markets: II' (1991) 46(5) *Journal of Finance* 1575.

<sup>82</sup> RJ Gilson and RR Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549, 550.

<sup>83</sup> HE Jackson, 'To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns' (2003) 28 *Journal of Corporation Law* 671.

<sup>84</sup> Although some contend that the connection between prices in the public trading markets for stocks and the allocation of real resources is a weak one, and that stock markets may have far less allocative importance than has generally been assumed: L Strout, 'The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation' (1988) 87 *Michigan Law Review* 613.

<sup>85</sup> FB Cross and RA Prentice, *Law and Corporate Finance* (Edward Elgar 2007) ch 3 provides an overview of behavioural analysis of law and corporate finance. See further, A Shleifer, *Inefficient Markets* (OUP, 2000).

theory contend that arbitrage will quickly eliminate pricing inaccuracies caused by investor irrationality, others point out that arbitrage is risky, subject to limitations, and that even professional investors cannot be relied upon to act with perfect rationality.<sup>86</sup> The deep debate on these issues makes it hard now to claim, as was done in 1978, that 'there is no other proposition in economics which has more solid empirical evidence supporting it than the efficient market hypothesis.'<sup>87</sup> It is open to question whether securities regulatory policy design has kept pace with this debate or whether it remains rooted in assumptions that arguably have been shown to be too simplistic to be wholly convincing as explanations for how securities markets operate. However, since there is overwhelming empirical evidence that share prices react quickly, in the expected direction, to the release of information, overall the theory of efficient capital markets continues to contribute usefully to the analytical framework.

### Measuring and assessing financial performance—company accounts

The definition of a semi-strong efficient capital market as one in which market prices shift rapidly in response to new information as soon as it becomes public, puts the spotlight onto the operation of processes whereby information is conveyed to the market and then impounded into prices. It has been said that: 'Since efficiency in the capital market depends on the distribution of information, it is ultimately a function of the cost of information to traders. The lower the cost of particular information, the wider will be its distribution, the more effective will be the capital market mechanism operating to reflect it in prices, and the more efficient will be the market with respect to it.'<sup>88</sup> Mandatory disclosure obligations eliminate the repetitive costs of individual acquisition of information by each market participant and, as such, they can be regarded as an efficiency-enhancing mechanism.<sup>89</sup> Regular reporting of financial performance is the central mandatory disclosure obligation to which companies are subject. This section therefore provides an overview of the UK mandatory financial disclosure obligations for companies and of the institutional framework within which they operate.

<sup>86</sup> A Shleifer and L Summers, 'The Noise Trader Approach to Finance' (1990) 4 *Journal of Economic Perspectives* 19 (stressing limits on arbitrage).

<sup>87</sup> MC Jensen, 'Some Anomalous Evidence Regarding Market Efficiency' (1978) 6 *Journal of Financial Economics* 95.

<sup>88</sup> RJ Gilson and RR Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549, 593.

<sup>89</sup> *ibid* 597–601.



**Statutory financial disclosure framework for UK companies**

The directors of every company must prepare accounts for the company for each of its financial years.<sup>90</sup> Before approving the accounts, the directors must be satisfied that they give a true and fair view of the assets, liabilities, financial position, and profit or loss of the company.<sup>91</sup> The accounts may be prepared in accordance with the Companies Act or in accordance with international accounting standards/international financial reporting standards (IAS/IFRS).<sup>92</sup> Companies Act accounts comprise a balance sheet as at the end of the relevant financial period and a profit and loss account covering that period.<sup>93</sup> These fundamental statutory requirements are amplified by accounting standards, which include a requirement for a cash flow statement.<sup>94</sup> Companies Act accounts are drawn up in accordance with the Act<sup>95</sup> and UK Generally Accepted Accounting Principles (UK GAAP), for which responsibility lies with the Accounting Standards Board (ASB).<sup>96</sup> The ASB favours the strategy of achieving the convergence of UK GAAP with IAS/IFRS.<sup>97</sup> A complete set of IAS/IFRS financial statements comprises a balance sheet, an income statement, a statement of changes in equity over the period, a cash flow statement, and notes.<sup>98</sup> International Accounting Standards and International Financial Reporting Standards are the responsibility of the International Accounting Standards Board (IASB).<sup>99</sup>

Subject to certain exemptions, directors of parent companies must also prepare consolidated group accounts for each year.<sup>100</sup> As a matter of European law, the consolidated group accounts of an issuer with securities admitted to trading on a 'regulated market' must be drawn up in accordance with IAS/IFRS.<sup>101</sup>

<sup>90</sup> Companies Act 2006, s 394.

<sup>91</sup> *Ibid* s 393.

<sup>92</sup> *Ibid* s 395.

<sup>93</sup> *Ibid* s 396.

<sup>94</sup> FRS 1, *Cash Flow Statements*.

<sup>95</sup> Detailed requirements are to be set out in Regulations made under Companies Act 2006, ss 396 (individual accounts) and ss 404 (group accounts). See The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008, SI 2008/409 and The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008/410.

<sup>96</sup> Companies Act 2006, s 464 makes provision for a body or bodies to be prescribed for the purposes of issuing accounting standards. This section is a re-enactment of an equivalent provision in the Companies Act 1985. The ASB is the prescribed body under The Accounting Standards (Prescribed Body) Regulations 2005, SI 2005/697.

<sup>97</sup> ASB, 'UK Accounting Standards: A Strategy For Convergence With IFRS', Discussion Paper (March 2004); ASB, 'Accounting Standard-setting in a Changing Environment: The Role Of The Accounting Standards Board', Exposure Draft (March 2005).

<sup>98</sup> IAS 1, *Presentation of Financial Statements*.

<sup>99</sup> Standards issued by the IASB are designated International Financial Reporting Standards but earlier pronouncements made by a predecessor body that remain in force are designated International Accounting Standards.

<sup>100</sup> Companies Act 2006, s 399.

<sup>101</sup> Regulation (EC) 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards [2002] OJ L243. This requirement is directly applicable in the UK. Companies Act 2006, s 403(1) notes its impact.

This requirement is applicable to issuers on the London Stock Exchange's Main Market and on the PLUS-listed Market, as these are both 'regulated' markets, but not directly to issuers on AIM or PLUS-quoted, which are 'exchange-regulated markets'. (However, under the rules governing admission to trading on AIM, there is a requirement for AIM companies incorporated in EEA countries to prepare and present their annual consolidated accounts in accordance with IAS/IFRS.<sup>102</sup>) The group accounts of other companies may be drawn up as Companies Act group accounts or as IAS/IFRS group accounts.<sup>103</sup> The financial statements required to be included in Companies Act or IAS/IFRS accounts are the same as for individual accounts but on a consolidated rather than an individual basis. The individual accounts of a parent company and each of its subsidiary undertakings must all be prepared using the same reporting framework except where there are good reasons not to do so.<sup>104</sup>

In addition to the accounts, the directors of a company must prepare a directors' report for each financial year of the company.<sup>105</sup> For a parent company that prepares group accounts, the directors' report must be a consolidated report.<sup>106</sup> Except for companies that are subject to a special regime for small companies, the directors' report must contain a business review providing a fair review of the company's business and a description of the principal risks and uncertainties facing it.<sup>107</sup> The prescribed contents of business reviews are more detailed for quoted companies than for unquoted companies.<sup>108</sup> A 'quoted company' for the purposes of the accounting requirements of the Companies Act 2006, includes companies whose equity share capital has been admitted to the London Stock Exchange's Main Market, or any other EEA market for officially listed securities, or which are admitted to dealing on the New York Stock Exchange or NASDAQ.<sup>109</sup> The directors of a quoted company are also required to prepare a directors' remuneration report for each financial year of the company.<sup>110</sup>

Subject to certain exemptions (including exemptions for small companies and dormant companies) annual accounts must be independently audited.<sup>111</sup> The auditor's report must state clearly whether, in the auditor's opinion, the annual accounts give a true and fair view, have been properly prepared in accordance with the relevant financial reporting framework, and have been prepared in accordance with the Companies Act 2006 and the IAS Regulation, where that

<sup>102</sup> AIM Rules, r 19.

<sup>103</sup> Companies Act 2006, s 403(2).

<sup>104</sup> Companies Act 2006, s 407.

<sup>105</sup> *Ibid* s 415.

<sup>106</sup> *Ibid* s 415.

<sup>107</sup> *Ibid* s 417.

<sup>108</sup> *Ibid* s 417(5).

<sup>109</sup> *Ibid* s 385.

<sup>110</sup> *Ibid* s 420.

<sup>111</sup> *Ibid* s 475.

is applicable.<sup>112</sup> The auditor must also state whether, in his or her opinion, the information given in the directors' report (including the business review) is consistent with the accounts.<sup>113</sup> For quoted companies, the auditor's report must include a report on the auditable part of the directors' remuneration report and must state whether it has been properly prepared.<sup>114</sup>

The process under the Companies Act 2006 for putting annual accounts and reports into the public domain is that they must be sent to every shareholder and debenture holder, and every other person who is entitled to receive notice of the general meetings.<sup>115</sup> The Companies Act 2006 makes provision for documents and other information to be validly sent in hard copy form, in electronic form, or by being made available on a website.<sup>116</sup> Quoted companies must, in addition, make their annual accounts and reports available on a website which is accessible by the general public and not just members and debenture holders.<sup>117</sup> There is also provision for summary financial statements to be sent to shareholders, debenture holders, and other entitled persons instead of the full accounts and reports but the full accounts and reports must be sent to any such person who so requests.<sup>118</sup> Public (but not private) companies must then within a specified period lay their accounts and reports before a general meeting.<sup>119</sup> Finally, all limited companies must file their annual accounts and reports with the registrar of companies.<sup>120</sup> Exactly what has to be filed depends on the type of company.<sup>121</sup> There is provision for small and medium-sized companies to file abbreviated accounts but unquoted companies (that are not SMEs) must file the full accounts and directors' and auditor's<sup>122</sup> reports, and quoted companies must, in addition, file the directors' remuneration report.

The time limits for fulfilment of these requirements are important because a big time-lag is likely seriously to diminish the value of the information provided by the accounts. Under the Companies Act 2006, the time limit within which a public company must lay its accounts before the general meeting and then file them with the registrar is six months from the end of the relevant accounting reference period.<sup>123</sup> For private companies the time period for delivery of accounts

<sup>112</sup> Companies Act 2006, s 495.

<sup>113</sup> *Ibid* s 496.

<sup>114</sup> *Ibid* s 497.

<sup>115</sup> *Ibid* s 423.

<sup>116</sup> *Ibid* ss 1144–1148 and Schs 4–5.

<sup>117</sup> *Ibid* s 430. Access can be restricted so far as necessary to comply with any enactment or regulatory requirement (in the UK or elsewhere); *ibid* s 430(3)(f).

<sup>118</sup> *Ibid* s 426.

<sup>119</sup> *Ibid* s 437.

<sup>120</sup> *Ibid* s 441.

<sup>121</sup> *Ibid* ss 444–448.

<sup>122</sup> Unless an exemption from auditing requirements applies and has been relied upon: *ibid* s 446(2).

<sup>123</sup> *Ibid* s 442.

to the registrar is nine months.<sup>124</sup> Even though the publication timescales were shortened by the Companies Act 2006, they still remain quite generous.

### **Additional financial disclosure framework under FSA *Disclosure and Transparency Rules***

The EC Transparency Obligations Directive requires Member States to impose disclosure requirements in relation to annual accounts, half-yearly financial reports, and interim financial statements (which are broadly equivalent to quarterly reports).<sup>125</sup> The UK fulfils this Community obligation via the *FSA Disclosure Rules and Transparency Rules (DTR)*. The *DTR* apply (with some exemptions) to issuers whose transferable securities are admitted to trading on a 'regulated market' and whose 'home State' is the UK. 'Regulated market' and 'home State' are regulatory concepts with considerable significance in EC securities law. For the purposes of this chapter, it can suffice to note that companies incorporated in the UK that have their equity share capital admitted to trading on the Main Market of the London Stock Exchange (which is a regulated market) are subject to the *DTR* financial disclosure rules but AIM and Plus-quoted companies, even if UK incorporated, are not; this is because AIM and the PLUS-quoted Market are 'exchange-regulated', rather than 'regulated', markets.

Under the *DTR*, audited annual reports must be published within four months of the year end (rather than the more generous six months permitted by the Companies Act 2006).<sup>126</sup> Annual reports must contain a statement from each responsible person within the issuer that to the best of his or her knowledge the financial statements give a true and fair view and the management report includes a fair review of performance together with a description of principal risks and uncertainties.<sup>127</sup> Half-yearly financial reports (which need not be audited) must be made public as soon as possible, but no later than two months after the end of the period to which the report relates.<sup>128</sup> The contents of half-yearly reports are prescribed in outline by the *DTR* as comprising a condensed set of financial statements, an interim management report, and responsibility statements.<sup>129</sup> In addition, in a period between ten weeks after the beginning, and six weeks before the end of each six-month period, an issuer must make public a statement by its management that provides an explanation of material events and transactions and their impact on its financial position, and also a general description

<sup>124</sup> *Ibid* s 442.

<sup>125</sup> Directive (EC) 2004/109 of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive (EC) 2001/34, [2004] OJ L390/38, Arts 4–6.

<sup>126</sup> *DTR* 4.1.3.

<sup>127</sup> *DTR* 4.1.12.

<sup>128</sup> *DTR* 4.2.2.

<sup>129</sup> *DTR* 4.2.3. See also IAS 34, *Interim Financial Reporting*.

of its financial position and performance during the relevant period.<sup>130</sup> Interim management statements need not be audited and there is no requirement for the inclusion of responsibility statements.

The *DTR* also address the process whereby information is disseminated to the public.<sup>131</sup> All regulated information must be disseminated in a manner ensuring that it is capable of reaching as wide a public as possible, and as close to simultaneously as possible throughout the EEA. It must also be communicated to the media in unedited full text (save for annual financial reports which can, generally, be edited). When regulated information is disclosed it must at the same time be filed with the FSA.<sup>132</sup> However, there is no requirement in the *DTR* for financial statements to be sent directly to shareholders (or others).

Market efficiency (and investor protection) aims underpin the Transparency Obligations Directive. Its first recital declares that:

Efficient, transparent and integrated securities markets contribute to a genuine single market in the Community and foster growth and job creation by better allocation of capital and by reducing costs. The disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency.

These sentiments owe much to the intellectual framework provided by the efficient capital markets theory.

#### **Additional financial disclosure framework for other publicly traded companies**

The rules of the market on which a company's securities are admitted to trading may impose financial disclosure obligations in addition to those under the general law. Under the *AIM Rules for Companies*, for example, AIM companies must prepare half-yearly reports, which must be published without delay and in any event not later than three months after the end of the relevant period.<sup>133</sup> The information contained in a half-yearly report must include at least a balance sheet, an income statement, and a cash flow statement. The half-yearly report must be presented and prepared in a form consistent with that which will be adopted in the company's annual accounts. AIM companies are not required to publish public quarterly reports or other interim financial statements. PLUS-quoted Market companies are subject to a similar obligation with regard to half-yearly reports and they must announce final results within five months of year end.<sup>134</sup>

<sup>130</sup> *DTR* 4.3.

<sup>131</sup> *DTR* 6.3.

<sup>132</sup> *DTR* 6.2.2.

<sup>133</sup> *AIM Rules*, r 18.

<sup>134</sup> PLUS Market *Rules for Issuers*, rr 30–31.

## PART II LEGAL CAPITAL