

THE TAKEOVER PANEL

**RAINE INDUSTRIES PLC ("RAINE") /
TARMAC PLC ("TARMAC") /
RUBEROID PLC ("RUBEROID")**

On 10 October, it was announced that the Panel executive had required Smith New Court PLC ("Smith New Court"), who are corporate brokers to Ruberoid, to make available to Moodscatter Limited ("Moodscatter"), an associate of Raine, one million shares in Ruberoid and to provide an underwriting facility to Moodscatter in respect of those one million shares on the terms of the cash alternative offer contained in Raine's bid for Ruberoid. This ruling was given following a Panel executive enquiry which found that Smith New Court had breached Rule 38.1 of the Code.

The Panel has considered what, if any, disciplinary consequences should follow from this breach of the Code. It has determined that the exempt market-making status of Smith New Court should be suspended for three months. Within this time, Smith New Court must satisfy the Panel executive that there has been put in place, and is successfully operating, a system which will ensure that there will be no repetition of this breach. If the executive is not so satisfied, it will be open to it to apply to the Panel for an extension of this suspension.

Background

The Rules relating to exempt market-makers were introduced in 1986 in the light of the creation of multi-service financial organisations. They are designed to ensure that market-makers within such an organisation can continue to operate as such, and not be regarded as acting in concert with clients of the corporate finance arm involved in a bid. The market-maker's actions must be kept separate from, and must not be influenced

by, the activities of the corporate finance arm of the organisation. The market-maker must be wholly insulated from the corporate finance arm, and that barrier must be strictly observed. In its statement headed Multi-Service Financial Organisations and the Take-Over Code, issued on 6 October 1986, the Panel stated:-

". . . when a multi-service financial organisation is (as banker, stockbroker or otherwise) advising an offeror, then all principal dealings in relevant securities by any part of that organisation will be presumed to be in concert with the offeror, with one important exception in respect of dealings in a market-making capacity, provided the market-maker concerned is an "exempt market-maker" as explained below.

The Panel accepts that in general it is the intention of multi-service financial organisations to run their market-making operations wholly independently and, in particular, without regard to the interest of clients of the corporate finance arm of the organisation. In addition the Panel has been particularly concerned to avoid damage to the liquidity of the market in relevant securities which might otherwise arise from a forced withdrawal of a significant market-maker at the time of the announcement of an offer because of its connection with the offeror. Accordingly, the Code is to provide for a category of exempt market-makers to whom the above-mentioned presumption will not normally apply. Market-makers who wish to seek this exemption should apply to the Panel. Amongst other things, an applicant market-maker will have to demonstrate to the Panel that the organisation in question has in place arrangements satisfactory to the Panel relating to the separation of the market-making side from other relevant parts of its business, in particular corporate finance.

Whenever another part of its organisation is acting for an offeror or an offeree company in a take-over, an exempt market-maker will have to adhere to the important general principle that it must not use its exemption to carry out transactions intended to assist clients of the advisory side."

Rule 38 gives effect to this principle.

Rule 38.1, and the Note on it, are in the following terms:-

"PROHIBITED DEALINGS

An exempt market-maker connected with an offeror or the offeree company must not carry out any dealings for the purpose of assisting the offeror or the offeree company, as the case may be.

NOTE ON RULE 38.1

Suspension of exempt status

Any dealings by an exempt market-maker connected with an offeror or the offeree company with the purpose of assisting an offeror or the offeree company, as the case may be, will constitute a serious breach of the Code. Accordingly, if the Panel determines that a market-maker has carried out such dealings, it will be prepared to rule that the market-maker should cease to enjoy exempt status for such period of time as the Panel may consider appropriate in the circumstances."

In a market where organisations are permitted to act in several capacities, the Rules aim to allow sensible working of the market whilst preserving the integrity of separation between the various arms of organisations. Strict compliance with the Rules is crucial. It is necessary for those responsible for overall management to make certain that an appropriate system is in place to ensure that the Rules are observed. It is also necessary for those responsible for compliance to ensure that in actual practice that system is strictly adhered to. It is imperative

that those acting in the market should know what the Rules are and should exercise the most rigorous self-discipline to stick to them. This task is no easier because of the potential close contacts between various members of the same organisation. But, precisely because of such contacts, the systems and the checks enforced have to be strict. While physical separation, wherever it can be obtained, is important, the system ultimately depends on individuals being aware of the Rules and complying with them strictly.

The Transaction

Raine announced its offer for Ruberoid in July 1988 and this bid was subsequently extended to 14 September. On 6 September, Ruberoid's advisers announced that an approach had been received from a third party. On 8 September, Tarmac announced a recommended offer for Ruberoid. In the offer announcement it stated that it owned 1.45 million Ordinary Shares in Ruberoid. These shares had been purchased on 6 September. When it emerged that they had been purchased from Smith New Court, given that this organisation was also corporate broker to Ruberoid, the Panel executive commenced an investigation. During this investigation, the executive received, as it would expect, full co-operation from Smith New Court.

The investigation established that there was no impropriety in the sale of 0.45 million of the shares. These were sold on behalf of an independent institutional client in the ordinary course of business. The position in regard to the balance of one million shares was, however, different. The facts are as follows.

On 1 or 2 September, the Smith New Court market-maker in Ruberoid contemplated selling half his long position in Ruberoid shares which then totalled approximately one million. He identified Hoare Govett, acting for Raine, as probable purchasers. He sought the advice of a senior director responsible for Smith New Court's equity market-making activities who advised him not to

sell to Raine on the basis that this could reflect on the position of Smith New Court since they acted as corporate broker to Ruberoid. In the light of Rule 38.1, this was clearly a consideration which should not have been taken into account and therefore amounted to a breach of the Rule, a ruling which Smith New Court has not sought to contest.

By 5 September, the market-maker remained concerned about the risk of holding one million Ruberoid shares. At this point a member of the agency broking team, who also acted as corporate broker to Ruberoid, was informed of the market-maker's wish to reduce his holding. The broker then warned Ruberoid that a block of Ruberoid shares was being offered for sale. As a result it was eventually arranged that the shares were purchased by a broker who it later transpired was acting for Tarmac. No-one at Smith New Court was aware of the identity of the purchaser. Tarmac, itself, was not aware that part of the 1.45 million shares came from Smith New Court. The transaction took place before Ruberoid's announcement the same day that it had received an approach from a third party.

It was not submitted by the executive to the full Panel that the market-maker effected this transaction for the purpose of assisting Ruberoid. It was, however, submitted that the corporate broker had used the market-maker's book to assist Ruberoid and that Rule 38.1 had accordingly been breached. Smith New Court accepted that its corporate broker should not have been informed of the size of the market-maker's book and should not have been given the opportunity to secure that those shares were purchased by a party friendly to Ruberoid. It was acknowledged that this breached the barriers which should exist. It was submitted on behalf of Smith New Court, however, that since the corporate broker was not part of the market-making arm there had been no breach of Rule 38.1. It was contended that this Rule only applied to those employed in the market-making arm. The Panel considered, however, that where the barrier between the market-making arm and the corporate finance arm of an organisation is breached, with the result that the corporate

finance arm sets out to facilitate the purchase of shares held by the market-maker by a party friendly to the offeree, then the corporate finance arm becomes party to the activities of the market-maker. In this case, the corporate broker on behalf of the organisation as a whole enabled the offeree to find an acceptable purchaser for the market-maker's shares. In such a situation the activities of all those in the organisation involved in the transaction can be taken into account in deciding whether a breach has occurred. Interpreting Rule 38.1 in accordance with the principle of separation it was designed to secure, the Panel considered that a second breach of the Rule had taken place.

The Consequences

There are substantial factors to be taken into account in favour of Smith New Court in considering the appropriate sanction for their breaches. The Panel has already stated, and wishes to emphasise, that Smith New Court co-operated fully with the investigation and never attempted to conceal in any way what had transpired. Raine has been restored as nearly as practicable to its original position at a significant cost to Smith New Court which may well be substantially increased. In addition, Smith New Court has taken measures internally to procure that there is no similar breach in the future.

The Panel has taken fully into account these aspects of the case. It considered anxiously whether it was possible in the light of them to deal with the issue solely by way of public censure. This, of itself, has potentially a serious impact. But the Panel concluded that this case demonstrated inexperience and incompetence on the part of a number of people within Smith New Court in an area which is of the utmost importance to the integrity of the market. The Panel considers that a breach of this kind is so serious that it must be marked by a period of suspension of exempt market-maker status. The minimum suspension of that status which can sensibly be imposed is a

period of three months, during which Smith New Court must satisfy the executive that its systems and procedures guard sufficiently against a further breach.

One consequence of this hearing will have been, yet again, to bring to the attention of the market the existence of the Rules, the importance of training staff in how to comply with them and the need for effective compliance to ensure that the Rules are in fact observed.

19 October 1988