SLAUGHTER AND MAY/

CLIENT BRIEFING

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ATTRACTING MORE IPOS TO LONDON: NEW LISTING RULES COME INTO FORCE

SUMMARY

- Companies with a certain type of dual class share structure can now list on the premium segment.
- The free float requirement for both the premium and standard listing segments has been reduced to 10%.
- A company must have a market capitalisation of at least £30 million when first admitted to the premium or standard segment.
- Details of further reforms to the listing regime, including possible changes to the three year track record requirement for the premium segment, are expected to be published in H1 2022.
- From 1 March 2022 asset managers and research firms will be able to provide research on certain quoted SMEs without having to comply with the FCA's inducement rules. This is intended to improve the quantity and quality of research on SMEs.

On 3 December 2021 the Listing Rules were amended to permit companies to list on the premium segment with a certain type of dual class share structure (DCSS) and to reduce from 25% to 10% the percentage of shares that a listed company must have in public hands (free float) from admission onwards. The changes, which are designed to attract more companies to list on the UK Main Market, reflect the IPO-related recommendations made by Lord Hill in his March 2021 report on the UK listing regime and by Ron Kalifa in his February 2021 review of UK fintech. At the same time, the minimum market capitalisation that a listed company must have on admission was increased from £700,000 to £30 million. Other minor and technical changes to the listing regime will take effect on 10 January 2022. Apart from the market cap threshold - which the FCA originally proposed to raise to £50 million - the changes reflect the FCA's original proposals in CP 21/21 (which were summarised in a briefing we published in July).

In addition, from 1 March 2022 asset managers and research firms will be able to provide research on SMEs with a market capitalisation below £200 million without having to comply with the FCA's inducement rules (which prohibit the bundling of research and execution fees). Certain other types of research will also be exempt. The change is designed to improve the quantity and quality of research on SMEs.

This briefing looks at the changes in more detail.

Dual class share structures (DCSS)

A DCSS typically involves a company having two classes of shares that are identical in all respects other than voting rights. One class of shares (the ordinary shares) carry one vote per share, and the other class (which are often unlisted) carry multiple votes per share, typically 10 or 20 votes per share. The high vote shares are typically held by the founder (and sometimes some or all other pre-IPO shareholders), while the ordinary shares are held by third party investors from admission. In the last few years, a number of high-profile companies have listed in the US with a DCSS, including Airbnb, DoorDash, Peloton, Slack, Lyft and Pinterest. Older examples include Facebook and Google-parent Alphabet.

Before 3 December 2021, a company with a DCSS could join the standard segment but not the premium segment. Recent examples include Oxford Nanopore Technologies, the Hut Group, Deliveroo and Wise. However, the inability to join the premium segment deterred some companies - especially fintech and "new economy" companies controlled by one or more founders concerned about losing control - from listing in London altogether.

To address this, the FCA has decided to allow companies to join the premium segment with a DCSS where:

- The high vote shares are unlisted and held only by directors of the company or beneficiaries of such a director's estate.
- The DCSS lasts for no more than five years after the company first joins the premium segment.
- The unlisted shares have weighted voting rights (up to 20 votes per ordinary share) in only two situations:
  - (i) On a resolution to remove the holder as a director, whenever this is proposed. This is designed to "entrench" the director for an initial period after IPO.
  - (ii) On any shareholder resolution required by the Listing Rules, but only after a change of control has occurred. This is designed to deter a takeover during that initial period.

The unlisted high vote shares can vote alongside holders of ordinary shares, on a one vote per share basis, on all other matters that require shareholder approval under the Listing Rules - such as major and related party transactions, cancellation of listing and transfer between listing categories.

Like other companies applying to join the premium segment, a company with such a DCSS must demonstrate it is capable of carrying on an independent business; and, if it has a controlling shareholder, it must put in place a relationship agreement and the other protections for non-controlling shareholders mandated by the Listing Rules.

Standard segment companies with a DCSS can transfer to the premium segment provided their DCSS already complies, or is brought into line with, the new requirements.

Comment

By broadening the listing options available to companies that want to have a DCSS, the FCA has certainly improved London's ability to compete with other markets for IPOs of founder-led growth companies. Founders that want to retain control via a form of DCSS or other governance structure that is not permitted on the premium segment continue to have the option of listing on the standard segment. The main disadvantages of doing so are that standard segment companies are not eligible for inclusion in FTSE UK indices, and their shares can be subject to a pricing discount as result of being admitted to a segment sometimes perceived to be "second tier". However, this may change if the FCA decides to reform and repurpose the listing segments: see further below.

10% minimum free float

Previously, both premium and standard segment companies had to have a free float of at least 25% on admission and on a continuing basis, although in some circumstances the FCA could accept a lower percentage if there was still adequate liquidity.

Shares are considered to be in public hands only if they are held by shareholders who have less than 5% of the total number of shares in a company. (Shareholders with holdings of 5% or more are assumed to have strategic holdings that do not provide liquidity.) Others who do not count for free float purposes include directors and their connected persons; shareholders who have the right to nominate directors; trustees of company employee share schemes and pension funds; and shareholders whose shares are subject to a lock-up for more than 180 days.

The 25% free float requirement usually meant that at the time of IPO key shareholders had to sell some of their shares, which could lead to under-pricing and loss of control, and/or the company had to issue new shares, which diluted existing shareholders. Some companies and founders concerned about these issues and the associated execution risks therefore chose to list on other markets, where free float requirements tend to be less onerous. (For example, the NYSE and NASDAQ also impose free float requirements, but do not specify an absolute percentage of issued share capital.)

To make London more competitive, the FCA has therefore decided to reduce the absolute requirement for both the premium and standard listing segments to 10%. As before, the requirement applies both on admission and on a continuing basis. However, the FCA no longer has discretion to accept a free float lower than 10%. If a listed company's free float falls below 10%, it will need to present the FCA with a plan to address the problem as soon as possible. No changes have been made to the rules on which shares count as being in public hands.

Due to the increase in minimum market cap, the free float shares will need to be worth at least £3 million on IPO, which will help ensure adequate liquidity.

The FCA has decided not to proceed with a suggested idea of requiring issuers to disclose on a regular basis the percentage of their shares that qualifies as free float for Listing Rule purposes.

Comment

By reducing the minimum free float requirement to 10% the FCA has removed one of the main barriers to listing on the Main Market, so this change is very welcome. It will also make it easier for companies to come to market via a direct listing.

In practice, many companies will want or need their initial free float to be significantly greater than 10%. For example, where the company needs to raise new funds; existing shareholders want to sell a significant proportion of their shares; the company wants to ensure there is sufficient liquidity in its shares going forward; and institutional investors participating in the IPO want to see a free float of greater than 10%.

Indices

As noted above, a main attraction of listing on the premium segment, rather than the standard segment, is eligibility for inclusion in the FTSE 350 and other key indices. A company with a permitted type of DCSS that joins the premium segment will be eligible for inclusion in the FTSE UK Index Series if it satisfies the eligibility criteria in the ground rules for that Series.

At present, those ground rules specify a minimum free float of 25% for UK incorporated companies and more than 50% for non-UK incorporated companies. The criteria for determining which shares count towards the free float are slightly different to those under the Listing Rules. The ground rules also require companies that are assigned a developed market nationality to have more than 5% of all the voting rights (including voting rights attached to shares that are not listed or traded) in the hands of unrestricted shareholders - i.e. holders whose shares count towards the free float under the ground rules.

In July, in response to the FCA's proposals, FTSE Russell published a consultation on possible changes to these eligibility criteria. Broadly, it asked whether:

- The minimum free float percentage should be reduced to 10% in line with the (now finalised) change to the Listing Rules.
- Where a company joins the premium segment with the new type of permitted DCSS, for the purposes of the requirement that more than 5% of all the company's voting rights are in the hands of unrestricted shareholders, the unlisted shares held by the founder should be taken to carry one vote per share - which they carry in most circumstances - or the number of votes (now finalised as a maximum of 20) that they carry on a resolution (i) to remove the founder as a director or (ii) on any matter following a change of control. If FTSE Russell decides to adopt the latter approach, a company with a DCSS that is targeting a free float of around 10% to 25% could find that, although it would satisfy the free float requirements under the Listing Rules, its securities would not be eligible for the FTSE UK Series.

The FTSE Russell consultation closed on 20 August 2021. FTSE Russell said it intended to communicate any updates to the FTSE UK Index Series ground rules once any changes to the Listing Rules had been confirmed; and that any updates would be likely to take effect from the March 2022 index review. No updates have yet been published.

£30 million minimum market capitalisation

For both premium and standard segments, the minimum market capitalisation that a listed company must have on admission has been increased from £700,000 to £30 million. (The £700,000 threshold had remained unchanged since 1984.) On admission, the expected aggregate market value of all securities, excluding treasury shares, must therefore be at least £30 million. The change does not apply to investment companies or companies that are already listed. Provided certain conditions are met, it also does not affect companies that have made a complete submission for a listing eligibility review on or before 2 December 2021 or shell companies (including SPACs) that are already listed and subsequently need to make an application to re-list following an acquisition.

Understandably, the FCA believes that companies with a sub-£30 million market capitalisation are better suited for admission to other markets such as AIM or AQSE Growth Market. In practice companies with such a low market capitalisation are unlikely in any event to want to join the Main Market.

Three year track record requirement

In CP 21/21 the FCA asked whether it should be more willing to allow companies seeking to join the premium segment to depart from the requirement to show a three year revenue-earning track record covering 75% of the business. The track record requirement can be particularly problematic for pre-revenue companies and companies that have made one or more significant acquisitions in the three years before IPO. For now, though, no changes will be made: instead, the FCA will conduct a more fundamental assessment of the track record requirement in conjunction with its wider review of the listing regime (see below). In the meantime, companies that may have difficulty satisfying the requirement will need to discuss with the FCA at an early stage what it will require for both eligibility and prospectus purposes.

Market segments and their rules: fundamental review

In CP 21/21 the FCA also sought views on some fundamental questions relating to the listing segments and their rules. For example, it suggested various ways in which the existing segments could be combined or re-purposed, and other possible changes to the eligibility criteria for the premium segment (for details see our July briefing). The FCA says it intends to publish a Feedback Statement on these issues in the first half of 2022.

Investment research on quoted SMEs

Under MiFID II-derived inducement rules introduced in 2018, asset managers must pay for research either directly out of their own resources or from a separately held research payment account (RPA) funded by specific research charges collected from clients. In other words, research must be priced separately (unbundled) from other services, such as execution services. With a separately held account, firms have to set a budget for research and regularly assess the quality of research received. In practice, most research is now paid for by asset managers out of their own resources.

Some market participants have argued that these rules have had the effect of reducing the quantity and quality of research on SMEs, with resulting adverse impacts on price formation, trading and liquidity and higher bid-offer spreads in respect of SME shares. These issues may also have discouraged some SMEs from seeking a listing.

In response, the FCA has decided that, from 1 March 2022, asset managers and research firms will be able to provide research on SMEs with a market capitalisation below £200 million without having to comply with these rules. This means that research on such companies could be provided by brokers to asset managers on a bundled basis (where asset managers make a single commission payment to brokers covering execution and research) or for free and this will not constitute an inducement under FCA rules. Certain other types of research will also be exempt.

Although this change will be welcomed by market participants, other structural changes are likely to be needed before we see a significant increase in the amount of research on SMEs.

Sources

The changes to the Listing Rules are set out in Policy Statement 21/22 which was published on 3 December. The changes to the rules on publishing investment research on quoted SMEs are set out in Policy Statement 21/20 which was published on 30 November 2021.

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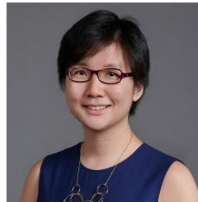

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