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FCA PUBLISHES BLUEPRINT FOR A NEW LISTING REGIME

Radical changes to the listing regime have been proposed by the FCA that are designed to attract more companies to list on the UK Main Market, and to encourage companies that are already UK-listed to retain their UK listing. Among other things, the premium and standard segments will be collapsed into a single segment for equity shares of commercial companies, and some of the eligibility criteria and continuing obligations that are currently more burdensome than their equivalents in most other major capital markets will be significantly relaxed.

A common theme behind all the changes proposed is that investors will generally be protected primarily via disclosure. Investors will therefore have to weigh up whether to invest in a company based on its ongoing disclosures and, at the IPO stage, whether to press the company to put in place specific protections - such as additional safeguards around major and related party transactions. As the FCA puts it:

> "*Market forces should ensure that capital is allocated to issuers whose overall business proposition and governance is acceptable to investors, tailored to the nature, scale and strategy of the company.*"

The proposals are set out in a FCA consultation paper published on 4 May 2023 (CP 23/10) and responses are sought by 28 June. We expect the rule changes to be introduced in late Q4 2023 or Q1 2024, although there is likely to be a transition period of several months to give companies time to transfer between segments and/or adapt to the new rules. This briefing summarises the main proposals and our view of them.

Overall package: our view

The UK is in danger of losing its position as the pre-eminent financial centre in Europe, and the London Stock Exchange is facing much stiffer competition from other stock markets in the EU, Asia and US. Government, regulators, banks, other market participants are all focussed on making improvements to ensure London continues to have a thriving capital market that attracts and retains home-grown and overseas companies. They won't always agree on the solutions needed, and some solutions that are adopted may subsequently need to be re-calibrated, but we need to seize this once-in-a-generation opportunity.

These proposed changes to the listing regime are part of a much wider set of initiatives to address the long-term decline in UK listings: for further details see the box on page 6, "*Other improvements to the UK capital markets ecosystem*". Removing regulatory burdens alone will not reverse the decline, but it will help to make UK markets more attractive to issuers, founders and financial sponsors. Although there has already been some very public push-back from some institutional investors about the reduction in protections, in our view the benefits outweigh the disadvantages and, overall, the proposals are welcome and timely. We will be involved in helping to refine the details over the coming months.

One segment for equity shares in commercial companies (ESCC)

The standard and premium listing segments of the UK Main Market will be replaced with a single listing category for commercial company issuers of equity shares. Generally, the eligibility criteria and continuing obligations for the new ESCC will be based on the current premium segment rules, but with some significant relaxations described below. There is a helpful table on pages 11-14 of CP 23/10 showing the proposed new regulatory framework and comparing it to the existing standard and premium segment rules.

There will be separate listing categories for equity shares issued by investment vehicles, OEICs and SPACs, and for non-equity securities such as bonds and preference shares: the rules relating to these will be left largely unamended. The rules for closed-ended investment funds may end up being amended in line with the new rules for commercial companies, but this is yet to be decided.

Comment

Although existing standard segment companies will need to make adjustments, and investors will lose some of the protections they currently enjoy, generally we think both companies and investors should welcome the idea of a new single segment. Despite some high-profile listings in the last couple of years, particularly by companies that wanted to retain after IPO a particular type of dual class share structure (DCSS) that would not have been permitted on the premium segment, the standard segment is commonly perceived as "second class" and is poorly understood. Another major disadvantage is that standard segment companies are ineligible for inclusion in FTSE UK indices. We agree with the FCA that it would be better to have a single segment with a single set of mandatory rules that are aligned more closely with other major listing venues. For this reason, we are also pleased the FCA has dropped the idea it previously floated of making all companies listed on the single segment subject to a set of "mandatory" continuing obligations but with the ability to opt in to further "supplementary" obligations.

Indexation will remain a key factor in a company's decision on where to list. Although indexation criteria are set by FTSE Russell and other index providers, and not by the FCA, collapsing the premium and standard segments into a single segment will compel index providers to update their criteria for inclusion in UK indices. As a starting point, all UK-incorporated commercial companies currently on the standard segment would in theory become eligible for inclusion in the FTSE UK indices. We would hope that FTSE Russell would embrace this opportunity for a more inclusive index, but it could decide to re-organise or sub-divide the UK indices to distinguish between companies according to factors such as liquidity, the level of protection given to investors via provisions in the company's constitution; corporate governance arrangements; and/or the nature of its public disclosures. FTSE Russell's approach will become clearer when it consults its users on changes to the inclusion criteria: we expect this to occur later this year.

Eligibility criteria for admission to the ESCC

As noted above, generally the eligibility criteria for the ESCC will be based on the current premium segment criteria. But some of the criteria that have historically made overseas listing venues seem more attractive to IPO candidates will be dropped. In particular, a company will not be required as a condition of listing to:

- demonstrate a three-year revenue-earning track record;
- ensure its historical financial information covers at least 75% of its business; or
- make a clean working capital statement.

However, unless the prospectus rules are also changed, a company will still need to include at least three years of historical financial information, and a statement about the adequacy of its working capital, in its IPO prospectus. (The same requirements apply to an IPO prospectus for an EU market.)

The current premium segment requirements around having an independent business and exercising operational control over main activities will be retained but modified to make it easier for "franchise" type companies and strategic investment companies to list.

Comment

Dropping the requirement for a three year revenue-earning track record is designed to encourage companies to consider listing at an earlier stage, particularly where the business model is based on first building out a product or platform, or acquiring subscribers, before deciding how best to monetise the product or services offered. Dropping the requirement for historical financial information to cover at least 75% of the company's business will make the path to listing easier for companies that have significantly increased their size through acquisitions in the three years before IPO.

But companies will in any event need to provide investors with sufficient information to enable them to understand and assess the previous performance and future prospects of the business. Where there is an overseas component to the IPO - for example, most UK IPOs currently include an offering to US institutional investors - the disclosures will also need to meet the standards and expectations of the overseas investors. An IPO candidate will also need to satisfy the diligence requirements of its financial advisers and underwriting banks around its financial track record and working capital position: these are likely to continue to go beyond the information that must be publicly disclosed.

Dual-class share structures (DCSS)

At present, where a founder wants to retain control of their company after IPO through a DCSS, in order for the company to be eligible for the premium segment the DCSS must comply with certain conditions. In particular, the "high vote" shares can cast multiple votes only on a resolution to remove the founder as a director or, following a change of control, on any matter (i.e. they can be used only to preserve the founder's position as a director or to deter a takeover); they can carry up to 20 times the votes carried by an ordinary share; and the DCSS must expire after no more than five years.

On the new ESCC, a DCSS will still have to satisfy certain conditions, but these will be more relaxed than on the current premium segment. In particular, the high vote shares will be able to cast multiple votes on any resolution proposed at any time, apart from a resolution to approve a discounted share offer; there will be no limit on the voting ratio; and it will be possible for the DCSS arrangement to last for up to 10 years. The high vote shares will have to be held by a director.

Comment

DCSS are widely accepted in the US, but they remain controversial in the UK, although UK investors will accept them in the right circumstances. But because the premium segment restricts the types of DCSS that are permitted, a company that wants to adopt a DCSS with a wider range of founder-friendly features must list on the standard segment – making it ineligible for inclusion in FTSE UK indices.

On the new ESCC, companies will not have a free hand to design a DCSS; but the proposed rules are sufficiently permissive to cater for most of the structures that have been used recently in the UK. Potential IPO candidates considering their listing options frequently ask about DCSS, so this change will certainly help London compete for listings against New York and Amsterdam, particularly when it comes to tech and founder-led companies.

Major transactions

At present, when a premium segment company proposes to enter into a non-ordinary course transaction, it must assess the size of the transaction using certain size indicators (class tests). If one or more of the class tests indicates that the transaction represents 25% or more of the value of the listed company (a Class 1 transaction), a circular containing certain prescribed information must be sent to shareholders and their approval obtained. An RIS announcement is also required.

On the new ESCC, shareholder approval will no longer be required for a Class 1 transaction. An RIS announcement will continue to be required, and it may have to include some of the key information that under current rules must be included in the circular. In addition, the “profits test” will be dropped from the class tests, because it frequently produces anomalous results; and there will be more flexibility for sponsors to modify the other class tests without needing permission from the FCA.

Shareholder approval will continue to be required for (i) a reverse takeover (although the definition of this may be amended); (ii) delisting; (iii) a non-pre-emptive share offer where the offer price represents a discount of more than 10% to the current share price; and (iv) certain buyback arrangements.

Comment

Removing the requirement to obtain shareholder approval for a Class 1 transaction will reduce cost and execution risk and potentially reduce timetables to closing. All these benefits will make it easier for UK-listed companies to compete with other (unlisted or overseas listed) bidders for assets. It will also bring the UK Main Market into line with other major listing venues which, with the exception of Hong Kong, do not require shareholder approval for such transactions.

Although some investors will be concerned about the loss of protection, those that regularly invest in international equities will be used to not having a vote. We expect companies considering doing a major transaction to continue to consult their major shareholders in advance, although the market abuse regime will constrain the timing and number of shareholders that can be consulted.

Exactly what information will have to be included in the announcement is yet to be determined. As the proposals progress, we will encourage the FCA to set the information requirements at a level that provides sufficient information to investors but without putting UK-listed companies at a significant disadvantage compared to other bidders for an asset.

The removal of the often anomalous “profits test” is also to be welcomed.

Related party transactions (RPTs)

At present, when a premium segment company proposes to enter into a non-ordinary course transaction with a related party (broadly 10%+ shareholders; directors; and their respective associates), it must assess the size of the transaction using the class tests. If the transaction’s class test value is 5% or more, a circular containing certain prescribed information must be sent to shareholders and their approval obtained; the company must obtain an opinion from a sponsor that the terms of the transaction are fair and reasonable as far as shareholders are concerned, and certain details must be announced. “Smaller” RPTs – where the value is above 0.25% but below 5% - are subject to reduced requirements.

On the new ESCC, shareholder approval will no longer be required for a transaction with a related party. However, most of the other controls on RPTs will be retained, including the requirement for an announcement and, for a larger RPT, a fair and reasonable opinion; and the RIS announcement may have to include some of the key information that under current rules must be included in the circular. The reduced requirements that currently apply to smaller RPTs will be dropped.

Comment

Similarly, removing the requirement to obtain shareholder approval for a RPT will reduce cost and execution risk and likely shorten deal timetables. All of this will bring the UK Main Market into line with other major listing venues, which generally do not require shareholder approval for such transactions.

Again, some investors may be concerned about the loss of protection. But companies will continue to be conscious that transactions with related parties are scrutinised by investors, media and (at the HY year or full year end) by auditors. Some companies may opt to beef up their controls around RPTs – for example, by establishing a board committee to review all RPTs above a certain size.

Companies with a controlling shareholder

At present, if a premium segment company has a controlling shareholder at the time of admission, or subsequently comes to have one, it must put in place a “relationship agreement” that includes certain prescribed terms designed to ensure that transactions with the controlling shareholder are conducted at arm’s length and on normal commercial terms. In addition, the (re)election of an independent NED and any proposed delisting must be approved by a majority of independent shareholders, as well as by all shareholders. If a company fails to comply, transactions between it and the controlling shareholder become subject to enhanced oversight under the RPT rules.

On the new ESCC, the existing rules around controlling shareholders will be retained in a modified form. In particular, it will no longer be mandatory to enter into a relationship agreement with a controlling shareholder: a company will be able instead to include in its prospectus and annual report an explanation of why it has not done so, alongside appropriate disclosure of the risks entailed. There will be no enhanced oversight of RPTs for failure to comply with the controlling shareholder regime. But a dual vote - of independent shareholders as well as all shareholders - will still be required to (re)elect an independent NED and to delist.

Comment

The controlling shareholder regime is widely perceived to offer fairly weak protection to other shareholders. Removing the requirement for a relationship agreement with a controlling shareholder may not be as significant as first appears. When a company comes to market with a controlling shareholder, investors may expect a relationship agreement to be put in place and, even if they do not, in some circumstances the company and/or its controlling shareholder may consider it useful to have a relationship agreement: for example, to specify what rights the controlling shareholder has to appoint directors to the board, to receive information or to sell shares in the company.

Sponsor regime

The sponsor regime will be retained but in a modified form. Companies on the new ESCC will require a sponsor when first applying for admission and on certain subsequent transactions; and a sponsor declaration to the FCA will be required on IPO. But a sponsor declaration will not be required on a Class 1 transaction.

Comment

We believe sponsors perform a valuable role and the FCA is right to retain them. However, we think that more could be done to educate the market, and particularly global investors, on the role they perform.

Next steps

The Consultation Paper does not include the text of any specific rule changes. Draft Handbook rules, a full cost-benefit analysis, and more details about the options for existing listed companies and the procedure for transferring between segments will be included in a further consultation paper to be published in the autumn. The Listing Rules will be substantially re-organised, with rules moving to different chapters.

As to when the new regime will take effect, the FCA says:

> *“Subject to consultation feedback and FCA Board approval, we are aiming for an accelerated timetable, with substantial progress by the end of 2023.”*

It therefore seems likely that the rule changes will be introduced in late Q4 2023 or Q1 2024, although there is likely to be a transition period of several months to give companies time to transfer between segments and/or adapt to the new rules.

Other improvements to the UK capital markets ecosystem

As the FCA notes, the regulatory regime is only one factor in a company's decision on whether to list and, if so, where. Other factors, which will often carry greater weight, include valuation; availability of capital; investor base; liquidity; peers; analyst expertise; taxation; director remuneration; indexation; founder and sponsor preferences; location of main operations, customer base or competitors; political support; and media coverage. Various other initiatives are currently planned or in progress to address perceived problems in a number of these areas: two examples are given below.

Implementing the recommendations of the Secondary Capital-Raising Review

In July 2022 the SCRR made 21 recommendations designed to make it easier, quicker and cheaper for listed companies to do a secondary (follow-on) equity fundraising: for further details see our client briefing. In response:

- In November last year, the Pre-Emption Group (PEG) updated its Statement of Principles. It now recommends that shareholders support AGM resolutions that permit a company to issue shares for cash on a non-pre-emptive basis in respect of up to 10% of issued share capital for any purpose and a further 10% for an acquisition or a specified capital investment that is announced contemporaneously with the issue or occurring in the previous 12 months (instead of 5% plus 5% under the previous version of the PEG Principles). A company that does a non-pre-emptive issue for cash is expected to comply with certain conditions, including observing "soft" pre-emption rights as far as practicable and giving due consideration to involving retail shareholders, and to file a post-transaction report with the PEG. To date, around 40% of FTSE 350 companies have taken advantage of the relaxation in the PEG Principles; take-up among FTSE 100 companies has been lower than among FTSE 250 companies.

- In February this year, the Investment Association updated its Share Capital Management Guidelines to permit companies to use the "second one-third" of their authority to issue new shares to be used for open offers, as well as rights issues. Take-up of this option has so far been limited, but we expect it to increase next year.

- Shortly we expect the Government to bring forward changes to the Companies Act designed, among other things, to make it easier and quicker for a company to do a large pre-emptive offer.

Investment research

In his "Edinburgh Reforms" speech in December 2022 the Chancellor committed to establish a formal review of the provision of investment research in the UK (the independent Investment Research Review), including the effects of the unbundling rules in MiFID. In broad terms, the aim is to improve the quantity and quality of investment research published on UK companies, particularly smaller cap ones, and hence to improve price formation and facilitate investment in public equities. In our experience, the relative lack of high-quality research has been one of the main concerns of companies when comparing the UK to other potential listing venues.

In April this year, HM Treasury sought views from market participants on, among other things, how investment research provision in the UK compares with other major international financial services centres and the amount, quality and type of investment research currently provided on companies that are listed or quoted, or seeking to be listed or quoted, on the UK public markets. The Investment Research Review is expected to publish its findings and recommendations later this year.

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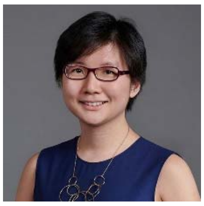

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