FCA Launches Consultation on Effectiveness of UK Primary Capital Markets and Amendments to Listing Rules

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Overview

On February 15, 2017, the UK Financial Conduct Authority ("**FCA**") published a **Discussion Paper (DP17/2)** seeking feedback on how the UK primary capital markets can most effectively meet the needs of issuers and investors. In particular, the FCA is interested in views on:

- the appropriateness of the boundary between the standard and premium listing categories, particularly in relation to non-UK issuers and exchange-traded funds ("**ETFs**");
- the effectiveness of the current regime in supporting early stage science and technology companies; and
- measures to support greater retail participation in debt markets and a role for a UK primary debt multilateral trading facility ("**MTF**").

In addition, in parallel, the FCA published a **Consultation Paper (CP17/4)**, which seeks to address issues that have emerged from the FCA's interactions with issuers and their advisers on transactions, by consulting on a number of proposed amendments to the Listing Rules as well as the introduction of a number of new and amended technical notes. Proposed changes include:

- clarifying the eligibility requirements for premium listing in Chapter 6 of the Listing Rules;
- introducing a new concessionary route to premium listing for certain property companies that cannot meet the three-year revenue-earning track record requirement;
- amending certain rules relating to the class tests for classifying certain transactions by premium listed companies and the obligation to consult with the FCA; and
- revising the FCA's approach to the suspension of listing on a reverse takeover.

The Discussion Paper includes a helpful primer on the UK's primary markets and the role of the FCA's listing regime, as well as some interesting broader commentary on market participants' views on current themes in equity capital markets, such as the attractiveness of London as a listing venue, IPO trends and long-term investment in public and private markets. This is supported by an appendix to the Discussion Paper containing a range of market data relevant to these themes. Influenced in part by its analysis of the data, the FCA determines that no wide-ranging changes are required to the regulatory regime in the primary equity markets and, in particular, the premium listing regime remains fit for purpose. As a result, the amendments to premium listing proposed in the Consultation Paper are limited primarily to technical enhancements rather than wholesale reform.

Responses to both papers are requested by May 17, 2017. The FCA has noted that given most of the proposals identified in the Consultation Paper are technical in nature, it considers it appropriate to address the proposed changes to the Listing Rules at this stage, and that this will not affect the broader, high-level discussion set out in the Discussion Paper. The FCA plans to publish its amended rules in a policy statement in the second half of 2017. To the extent that the FCA decides to take forward any specific policy proposal identified in the Discussion Paper, it will issue a further consultation paper, which will, to the extent required, take into account the impact of changes in the UK regulatory framework as a result of negotiations relating to the UK's vote to leave the EU. Separately and further to its April 2016

Discussion Paper (DP16/3), the FCA has confirmed that it plans to consult shortly on how to improve the information available in the UK IPO process.

Appropriateness of the Standard Listing Regime

The FCA notes that the standard listing segment, which enables UK issuers of shares that are unable to satisfy the eligibility requirements or comply with the continuing obligations of a premium listing to benefit from the same level of capital markets regulation as peers admitted to trading on other EEA regulated markets, suffers from a perceived lack of clear identity among market participants. Such issues of perception are compounded by the fact that standard listed shares do not benefit from inclusion in FTSE indices, which deters many investors.

Of 339 securities assessed by the FCA and classified with a standard listing, 223 were made up of second lines of securities, such as preference shares, where the issuer has other securities admitted to another listing category, for example, premium listing; and securities issued by closed- and open-ended funds that were admitted before standard listing was closed to such issuers in 2007. Seventy-one securities appeared to be a primary listing, in most cases where issuers are unable to comply with provisions of the premium listing regime, making them ineligible for premium listing. Finally, 45 securities reflect secondary listings of large overseas companies. Although a continuing feature of the market, the FCA notes that overseas companies cancelling their UK listings (possibly to rely solely on a primary overseas listing) is the second largest source of company delistings.

Apart from seeking general feedback on the rationale for a standard listing and whether the name itself is unattractive, one idea the FCA is keen to explore further is an alternative, international segment for large overseas companies. The rationale the FCA gives is to create a new, credible listing option for large international companies that may wish to access the UK markets but may feel that current UK listing requirements are not fully appropriate, such as companies where there is a founding family or government that wishes to retain control rights that are incompatible with a conventional premium listing. Features identified that such a segment might include are the requirement to appoint a sponsor, substantive eligibility conditions and application of the current related party rules, with other premium listing features on a "comply or explain" basis. Questions raised by this proposal include whether it meets a real market demand that is not currently catered to outside of the premium listing segment, the extent to which it is targeted at only a handful of companies with the types of features that caused high-profile business scandals, investor outcry and a tightening of the premium listing regime in 2014, and whether FTSE index inclusion would be available.

In addition, although the FCA decided in 2007 to make premium listing the exclusive route to market under the listing regime for investment trusts and investment companies in order to ensure appropriate levels of investor protection, it is now seeking to gather stakeholder views as to whether requiring premium listing is unnecessarily demanding for ETF issuers when compared with the limited benefits provided by the requirements in Chapter 16 (Open-ended investment companies: premium listing) of the Listing Rules.

Support for Early-Stage Science and Technology Companies

In the Discussion Paper, the FCA is eager to explore whether enhancements to the primary market regulatory regime could help address the difficulties that are perceived to face companies moving from early "start-up" stage, where commentators think that the UK provides a supportive environment for such businesses, to the subsequent "scale-up" phase, where less capital may be readily available from willing investors, particularly to the extent that there is a view that public equity markets are failing in this regard. Linked to this, the FCA returns to the theme of short-termism in the UK secondary capital markets, which has been in the headlines since the 2012 Kay Review brought the issue to greater public prominence. Examples noted are increasing calls for listed companies to stop voluntary quarterly reporting and the

impact market abuse rules have on investors' ability to have candid discussions with the companies they own. To the extent that conditions such as these and existing market structures create an environment that is unsuited to companies in need of "patient capital," such as science and technology companies, the FCA wants to explore any improvements that can be made to the effectiveness of primary and secondary markets in supporting a more patient approach. The Financial Reporting Council's **Stewardship Code** and establishment of the **Investor Forum** are cited as recent examples of such improvements.

Retail Access to Debt Markets and Debt MTFs

Another area for focus in the Discussion Paper is whether steps could be taken to facilitate retail access to straightforward debt instruments issued by established corporates, including alongside wholesale investors and on the same terms. This would require the FCA to reassess its recent guidance on prospectus disclosure in the context of the retail bond market and its approach to retail debt prospectuses satisfying the "easily analysable and comprehensible" requirement, which applies to prospectuses generally. Some market participants argue that the scope of this current guidance provides a disincentive for large, established corporate issuers that usually target institutional investors to issue straightforward bonds to retail investors, as they would need to reformat their documentation for a retail audience.

Finally, the FCA wishes to explore further whether the UK lacks an effective wholesale debt MTF, similar to European equivalents such as Ireland's Global Exchange Market (GEM) and Luxembourg's EuroMTF, which are exchange-regulated markets, as opposed to the UK Professional Securities Market, which is subject to the FCA's Listing Rules. It is seeking feedback on whether a specialist wholesale bond MTF could be a commercially viable option without recognised stock exchange status (which is a prerequisite to benefit from the quoted Eurobond exemption, for example), whether the creation of a wholesale bond MTF would be in the wider interests of investors, and what the key elements and disclosure requirements of such an MTF might look like.

Clarifying the Eligibility Requirements for Premium Listing

Based on market feedback, the FCA is satisfied that the premium listing segment works well. However, in light of a number of amendments to Chapter 6 of the Listing Rules over the years, the FCA contends that the drafting has, in places, become difficult to interpret. Therefore, the FCA proposes to reorder the chapter and amend provisions to simplify and clarify the existing provisions and, in certain cases, to explain the operation of the rules through further additional guidance by way of technical and procedural notes in the **Knowledge Base**. Proposed amendments include:

- stating explicitly in LR 6.2.4R that additional financial information (which may be required where there have been acquisitions during the three-year track record period) needs to be audited;
- making it clearer in LR 6.3.1R(1) in relation to the three-year financial track record that only a company that has been generating revenues in its declared line of business for the past three financial years can demonstrate that it is eligible for premium listing. In addition, another Technical Note (UKLA/TN/102.1), with further guidance on how to interpret the track record requirements, is proposed;
- deleting the guidance in LR 6.1.13G to LR 6.1.15G, which explains where the FCA might waive the requirement for financial information and a track record, on the basis that the FCA does not normally waive these requirements; and
- splitting the existing independence rules in LR 6.1.4R into three separate provisions: a rule on the need to carry out an independent business per se; a rule that clarifies the need to have a business independent of any controlling shareholder; and a rule that clarifies that the issuer must control its business. This will be accompanied by guidance that sets out factors that may indicate

that the issuer does not comply with the rules, and a new Technical Note (UKLA/TN/103.1) to help interpret the rules and give examples of what might be seen as improper influence.

Premium Listing for Property Companies and Other Concessionary Routes

Ordinarily, commercial companies that apply for premium listing are required to have a three-year revenue-earning track record in order to be eligible. However, for mineral companies and scientific research-based companies there are specific rules that exempt such issuers from these requirements to enable them to gain a premium listing by complying with other conditions. These concessions recognise that companies in these sectors have special attributes and that a three-year revenue-earning track record may say little about the value of the company. On a similar basis, the FCA proposes to introduce a new concessionary route to premium listing in LR 6.12.1R for certain property companies where a property valuation report will be considered in place of a financial track record. The two subcategories of property companies that the FCA believes may benefit from a concession are:

- companies that have been established for fewer than three years, but predominantly hold mature, let assets that generate revenue. The track record of these companies as the current "holding vehicle" of the assets is arguably less important than the performance of the assets themselves. An example may be a spin out of a mature portfolio. For such companies, property valuation reports will provide key information for assessing the value of the company; and
- property companies that develop assets, and have done so for three years, but focus on long-term projects that may only be revenue-generating after many years, if not decades. For these companies, the issuer's ability to demonstrate successful development activity representative of its long-term strategy through several years of increases in the value of the assets on its balance sheet, and supported by the property valuation report, will be much more informative than revenue figures.

In addition, the FCA is replacing the existing Technical Note for scientific research-based companies with a new Technical Note (UKLA/TN/422.3) and introducing a new Technical Note (UKLA/TN/427.1) for mineral companies, with the aim of providing additional guidance on the interpretation of the existing concessions.

Classifying Transactions for Premium Listed Companies

When classifying transactions for the purposes of LR 10, issuers are only required to approach the FCA if they believe that the class tests, when prepared in accordance with the rules in LR 10 Annex 1, produce an anomalous result or are inappropriate given the company's activities. In these instances the FCA may agree either that adjusted figures can be used in a class test or that appropriate substitute tests can be used. Based on feedback from market participants and its own experience, the FCA notes that it is clear that issuers that classify transactions frequently question whether the profits test result is an accurate representation of the size of the transaction. As a result, the FCA is proposing two changes in its approach to the profits test:

- to permit premium listed issuers to disregard the profits test where the result is 25% or more and this result is anomalous, and all other class test results are under 5%. This will result in the transaction being treated as unclassified, and would mean that the issuer no longer has to consult the FCA in relation to these transactions. The requirement for an issuer to obtain a sponsor's guidance under LR 8.2.2R will remain; and
- allow premium listed issuers, having sought guidance from a sponsor, to make certain adjustments – for a limited number of genuine one-off costs and historic financing costs – to the profit figures they use in their profits tests where the profits test result is 25% or more and is anomalous, without having to consult the FCA.

For all other situations where the premium listed issuer considers that the profits test produces an anomalous result, the FCA proposes to keep its existing requirement that the issuer must consult it if the issuer wants to modify the way it applies the profits test rules. This would include related party transactions (subject to the requirements of Chapter 11 of the Listing Rules) and class 2 transactions where the issuer is not required to seek the guidance of a sponsor.

In addition, the FCA is seeking views on other possible enhancements to the calculation of the profits test. This includes whether there are other adjustments to profit before tax that should be permitted to be made on the guidance of a sponsor without having to agree them first with the FCA; and also whether other profit measures should be used in the class tests, whether in place of or as well as the current profits test.

Finally, the FCA proposes to change its guidance relating to adjustments required in relation to the figures used to classify assets and profits in calculating the class tests, currently contained in Technical Note (UKLA/TN/302.1) into a rule in LR 10 Annex 1, to make it explicit that figures used in such class tests must be adjusted for transactions completed during the financial period to which the figures relate, in addition to the existing requirement to adjust for transactions (such as acquisitions and disposals) entered into by either the issuer or the target after the year-end (or publication of the interim balance sheet, where relevant).

(Reversal of) Suspension of Listing for Reverse Takeovers

In a significant move, the FCA proposes to remove the guidance for certain listed companies to provide the FCA and the market with specified information in order to ensure that the FCA does not suspend the listing of the company's securities in a reverse takeover situation. The FCA currently assumes that when a proposed reverse takeover becomes public, the market in the acquiring company's securities will not be able to operate smoothly because there will be insufficient information about the proposed transaction for proper price formation to develop. Therefore, in order to prevent a disorderly market, the FCA has the discretion to suspend the issuer's listing unless specified information on the proposed target company (broadly equivalent to the information required for a listed company) is publicly available. Under the proposals these assumptions will no longer apply. Instead, the FCA will assume that proper price formation can happen on the basis of the information that listed companies already make public as part of their compliance with other existing obligations, principally disclosing inside information under the Market Abuse Regulation.

The FCA is proposing these changes based on its experience of reverse takeovers and market participants' feedback that, for most companies, there is no need to suspend listing in a reverse takeover situation to avoid a disorderly market. Rather, there is sufficient information publicly available to ensure smooth operation of the market and so a suspension of listing is unnecessary. The changes proposed will apply to premium and standard listed issuers other than shell companies – namely, companies whose assets consist solely or predominantly of cash or short-dated securities; or whose predominant purpose or objective is to undertake an acquisition or merger, or a series of acquisitions or mergers – for which the FCA believes that different considerations apply. Consequently, the FCA is proposing a new Technical Note (UKLA/TN/420.2) on cash shells and SPACs to replace its existing guidance.

As a result, the FCA proposes to remove the obligation for issuers (other than shell companies) to contact it as early as possible to discuss whether a suspension is appropriate before announcing a reverse takeover that has been agreed upon or is in contemplation. It also proposes to remove the obligation for issuers to request a suspension where details of the reverse takeover have leaked (LR 5.6.6R). However, the FCA does not propose to change its general position that it may still suspend listing if it considers that the issuer is unable accurately to assess its financial position and inform the market accordingly (LR 5.1.2G(3)), or where there is insufficient information in the market (LR 5.1.2G(4)). In this context, the FCA will not be treating reverse takeovers differently from class 1 transactions.

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Conclusion

If there is a theme to be drawn from nearly 200 pages of FCA discussion and consultation, it seems to be about maintaining the relevance and attractiveness of the UK's primary markets to existing public companies and potential future issuers, particularly against a backdrop of growing international competition among listing venues and stock exchanges, ever-increasing reporting requirements for publicly traded companies and the perceived advantages for companies in certain sectors to remain private for longer, but without forsaking certain of the corporate governance and other investor protections that London is known for.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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