



Association of British Insurers

Encouraging **EQUITY** **INVESTMENT**

Facilitation of Efficient Equity
Capital Raising in the UK Market

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Introduction

Equity financing through the capital markets plays a crucial role in the economy. Equity capital has a continuing claim on corporate earnings and can be used to finance projects with uncertain and long-term returns, including research and product development. Companies need equity to invest and grow and to generate the returns needed to service debt and other forms of capital. Equity is the bedrock of economic growth.

The Kay Review raised some questions about the role and value of public equity markets and there have, in recent years, been various expressions of concern or discontent about the way in which the London equity market operates. ABI members who, as institutional investors have more than £1.8 trillion of funds under management, have a strong interest in ensuring the continued health of the UK equity market, including a flow of high-quality companies coming to the market as well as maintaining the competitiveness of London as a financial centre.

Against this background, the ABI has conducted an extensive review of processes for both Initial Public Offerings (“IPO”) and secondary capital raisings. This has involved discussions with not only a large numbers of institutional investors, but also a wide range of other market participants and other interested parties, including issuers, vendors, investment banks, lawyers, accountants, independent advisers, providers of independent research and regulators.

Overall, market participants do not believe that the UK model is fundamentally broken. Nonetheless, there are some areas that can be addressed with the aim of improving the efficiency of the process and the attractiveness of the London market.

We hope that you find the information and recommendations useful and look forward to working with you in ensuring the continued health of the UK public equity market.

Summary and Recommendations

1. INTRODUCTION

London is one of the world's leading financial centres and the largest in Europe. It holds this position because of a wide range of factors including:

- the large pool of institutional investors who manage funds in the UK on behalf of both British and international investors,
- the lower cost of capital for companies issuing shares as a result of efficient market structures,
- the high quality of business support available to companies irrespective of size and origin, and
- the stable legal and regulatory regime.

London and New York attracted 41% and 23%, respectively, of all cross-border IPOs between 2001 and 2011¹. For companies that are considering listing in the UK, the most commonly considered alternative is listing in the US.

Maintaining a competitive and attractive environment is therefore critical to London's future as an international financial centre.

2. INITIAL PUBLIC OFFERINGS ("IPOs") IN THE UK

Following the financial crisis, there have been expressions of discontent in the market with regard to the IPO process. These concerns have led to a perception among some commentators that the IPO process in the UK is broken.

On the whole, market participants do not believe that the UK model is fundamentally broken. Rather, the negative perception of the IPO market has prevailed because its health and success relies on confidence and momentum in the general market. This has been lacking for a number of years (although there has been an improvement in sentiment in the first half of 2013).

Nonetheless, there are areas that can be addressed with the aim of improving the efficiency of the process and the attractiveness of the London market.

Information Asymmetry / Price Discovery

An information asymmetry exists in favour of issuers and vendors at the expense of investors.

It is crucial that the IPO process addresses this imbalance to ensure that investors can understand the investment case and value the asset appropriately.

Early engagement, many months ahead of an IPO, between investors and issuers is seen by all parties as an excellent way of beginning the process of addressing this information asymmetry.

While pre-deal research prepared by syndicate analysts ("connected research") is still seen as valuable by investors, they believe it is important to increase the ability for non-connected independent analysts to access information and publish research before pricing.

Publishing the prospectus earlier in the IPO process will enable investors to be better prepared for the management roadshow and to give more incisive feedback on the company and its valuation ahead of setting a price range, so improving the price discovery process for all parties.

¹ Source: PWC, "Equity sans frontières" – Trends in cross-border IPOs and an outlook for the future, November 2012

If the prospectus is published early and fully approved by the UK Listing Authority (“UKLA”) at this point, there is likely to be more published independent analysis ahead of pricing.

However, in order to achieve this, there is a need to eliminate the market practice of separating pre-deal research and the prospectus – the initial part of the research blackout period. The barrier to this lies in persuading issuers’ and underwriters’ internal counsel that the risks of having legal action taken against them by institutional investors, either in the UK or the US, are minimal.

Key Recommendations

We encourage the practice of early engagement by issuers and vendors with investors up to a year or more before a planned IPO. This should be seen as an integral part of the IPO process.

Investors should ensure that the appropriate resource is committed to such early engagement, even - or particularly - when the IPO pipeline becomes very busy.

A prospectus approved by the UKLA, which is complete apart from pricing or price range and related information, should be issued at least one week earlier than the Pathfinder or Price Range prospectus² is issued in current practice.

- This will require eliminating the delay between publication of connected research and the offering document.
- It should be achieved by obtaining regulatory clarification from the FCA that:
 - they will not regard connected research, if prepared and identified appropriately, as part of the prospectus,
 - publication close to the time of the prospectus will not necessarily compromise its independence (in the sense that it is independent of the company), and
 - therefore, temporal separation between connected research and prospectus publication is unnecessary³.
- This should eliminate any residual UK risk for issuers and underwriters and it will, as a matter of evidence, reduce the likelihood of any successful action in jurisdictions outside the UK.

As a result, the typical timetable for an IPO, once the Intention to Float Announcement (“ITF”) has been made, could be shortened by one week, from four to three weeks (although it could remain longer for a particular issue, if desired).

The IPO process should allow at least one of two

alternatives to promote the publication of independent research:

1. Issuers and underwriters should allow greater access for non-connected analysts to the IPO analysts’ presentation or a subsequent similar presentation, such that they are able to have the same information as connected analysts.
 - The regulatory clarification by the FCA mentioned above will mitigate risks that companies may be liable for the content of such research.
2. Alternatively, non-connected analysts should be able to publish and distribute research with reference to a prospectus published immediately after the ITF that has been fully approved by the UKLA.

Syndicate size

An efficiently functioning syndicate is crucial to addressing the information asymmetry, effective price discovery, the distribution of the shares and the establishment of a stable shareholder base.

Although there are reasons that seem to explain the increase in size of syndicates in recent years, it is not clear that in the UK this is additive to the process, and the strong preponderance of opinion is in favour of smaller syndicates.

However, where appropriate, it would be helpful to include an ability to access retail investors for IPOs of companies listing in the Premium segment, and syndicate members that are required to achieve this.

Key Recommendations

As a rule of thumb, no more than three bookrunners should be appointed for large transactions, which we suggest is above £250m excluding any over-allotment option. Below this issue size, there should generally be no more than two bookrunners.

Issuers should ensure that any additional members of the syndicate are additive to the process due to their sector expertise or distributional reach.

We discourage the inclusion of syndicate members who are present solely on the basis of past or future services to the issuer or vendors.

Nonetheless, we acknowledge that vendors and/or companies may from time to time need to appoint more

² The Pathfinder prospectus is a marketing document distributed to institutional investors during an offering. It is not approved by the UKLA (unlike a stamped Price Range prospectus which is typically issued during offerings with a retail tranche).

³ This is likely to require clarification of the FCA’s Conduct of Business Rule 12.2.12G.

banks to the syndicate due to on-going relationships. In these instances, companies should specify clearly to each syndicate member their roles and responsibilities. This could include an entirely passive role within the transaction.

Issuers, with the assistance of independent advisers if appropriate, should scrutinise the allocations carefully to ensure that shares are being distributed to those most likely to be long-term shareholders.

We encourage issuers and vendors to consider including a retail tranche when listing in the Premium segment.

Fees

Although fees at IPO are in effect paid by the issuer, vendors or existing pre-IPO shareholders (with new investors able to take account of overall costs in the price they are prepared to pay), new investors at IPO retain a significant concern with the overall level of fees. Greater transparency of the composition of the fees paid to all parties at IPO will help address this concern.

Investors would like to have some ability to influence the award of incentive fees to create a degree of alignment in the assessment of the success of the transaction between them and issuers, vendors and the sell-side.

Such success should be measured over a period of longer than a few days after pricing. Some elements of the incentive fee will only become evident once the company has released its first set of results as a listed company.

Key Recommendations

There should be as a matter of good practice greater disclosure in the prospectus of all the fees paid for an IPO, including the maximum incentive fee, if any. This should include a breakdown of fees as a percentage of the size of the offering, and those fees that are independent of size, such as, but not limited to, independent advisers', lawyers' and accountants' fees. Syndicate members' individual fees should also be disclosed.

The final determination and payment of incentive fees in an IPO should be made at the later of the release of the first quarterly results of the issuer as a listed company and three months after listing. The amount paid should be disclosed to the market at the time of award.

The following criteria should be taken into consideration when awarding the incentive fee:

- the stability of the share price in the newly listed environment,
- the allocation of the shares of the issuer to a predominantly long-term shareholder base, as evidenced by the stability of the share register in the aftermarket,
- the extent and quality of the syndicate research both, during and after the IPO in the eyes of the investors,
- the continuity of research coverage post IPO.

A mechanism should be re-established for investors to give input into the allocation of the incentive fee, but on an anonymous basis.

Free Float and Corporate Governance

Free float is a key area of debate between all parties.

The current minimum of 25% for a Premium or Standard listing is seen as a barrier to listing on the UK Main Market by vendors, investment banks and independent advisers. It is seen by many sell-side banks and vendors as being one of the most important reasons to choose a US listing as opposed to a UK listing as it limits flexibility in combination with pricing.

Investors want to see a flow of high-quality, well-prepared and well-run companies coming to the market. Many continue to see liquidity as an important element in this.

There is strong support from all parties to strengthen the corporate governance standards of companies with controlling shareholders. This would include imposing certain compliance responsibilities directly on controlling shareholders.

Investors' concerns about weak corporate governance in the Standard segment are likely to be exacerbated if the free float is lowered from the current minimum without raising the protection for minority investors to levels that exist currently in the Premium segment. Any lowering of free float in the Standard segment might attract more issuers, but is unlikely to attract more investors to match such issuance unless corporate governance standards are raised.

There is general support for the recommendations of the FSA/FCA consultation paper CP12/25⁴ in relation to independent Boards and relationship agreements.

There is also general support for the idea that controlling shareholders should be required to take responsibility for certain specified statements in and contents of the prospectus and to have responsibility to the UKLA for compliance with the relationship agreement.

Additional responsibilities on controlling shareholders are likely to be helpful in focussing their attention on the disclosure and nature of their relationships with the company and minority shareholders. Discouraging controlling shareholders who are not willing to take on such liability from listing on the London market is a good outcome for the quality of companies that list here.

Some investors would consider a lower free float level requirement in the Premium segment than the current minimum of 25%, if governance were strengthened as outlined above, subject to meeting the minimum liquidity required under Article 48 of CARD⁵.

However, the majority of investors still believe that 25% should be the minimum free float level for Premium listed companies.

The sell-side is supportive of lowering the free float minimum in both Premium and Standard segments.

We recognise the need to balance the desire of investors to have an independent Board in place well before an IPO and that of the private owners to retain control in the event of a failed flotation.

Key Recommendations

Controlling shareholders should have liability for the prospectus at IPO for companies seeking a Premium listing. This would cover:

- a controlling shareholder or shareholders acting in concert with holding(s) of 50%+1 pre-IPO. The threshold should be set at this level because, in a private company, the shareholders are not as dispersed as in a public company where 30% is taken as the usual level of de facto control,
- any pre-IPO shareholder who will be party to a relationship agreement post-IPO.

The UKLA would need to identify those acting in concert on a case by case basis when considering eligibility for listing.

Controlling shareholders should:

- be required to include a responsibility statement in the prospectus covering certain statements included in the prospectus regarding future conduct of the business, including their future relationship with the company. This will require a change to Chapter 6 of the UKLA Listing Rules.
- have liability based on the current US model where, broadly, they can be held liable to the same extent as the issuer unless they can establish they acted in good faith and did not directly or indirectly induce the acts of the issuer constituting the violation⁶.

The FCA is also able to amend PR5.5.3⁷ (and to limit the scope of PR5.5.7⁸) to provide for controlling shareholders to be persons responsible for certain content of prospectuses in a wider range of circumstances and so to implement these changes.

A relationship agreement should be required between controlling shareholder(s) and the company. This should include a contractual obligation on the controlling shareholder(s) to comply with the statements included in the prospectus for which they have accepted responsibility. It should be publicly available and any material changes put to a shareholder vote. In addition, the controlling shareholder(s) should have a direct regulatory responsibility to the UKLA for adherence to the provisions of the relationship agreement:

- the UKLA's statutory power to sanction breaches of the Part 6 rules is contained in s91 FSMA 2000. There is no statutory authority for fining or censuring shareholders of issuers for breaching Listing Rules,
- the UKLA would therefore require additional regulatory authority through primary legislation (an amendment to FSMA 2000) in order to allow it to make Listing Rules that impose obligations on controlling shareholders and to enforce those rules directly.

There should be a phased appointment of independent directors in the months leading up to the IPO. An independent Board should be in place at the latest one month ahead of announcing the intention to float. The requirement for an independent Board should be a continuing obligation once the company is listed under the Listing Rules.

The minimum free float for Premium and Standard listings should be maintained at 25%. The majority of investors will not contemplate a reduction in the free float requirements

⁴ FSA Consultation Paper CP12/25 (Oct 2012): Enhancing the effectiveness of the Listing Regime and feedback on CP12/2

⁵ CARD: Consolidated Admissions and Reporting Directive. Article 48, para 5. A sufficient number of shares shall be deemed to have been distributed either when the shares in respect of which application for admission has been made are in the hands of the public to the extent of a least 25 % of the subscribed capital represented by the class of shares concerned or when, in view of the large number of shares of the same class and the extent of their distribution to the public, the market will operate properly with a lower percentage.

⁶ Section 15 and section 20(a) of the US Securities Exchange Act of 1934

⁷ Prospectus Rule PR5.5.3 describes who is responsible for the prospectus in an offering of equity shares

⁸ PR5.5.7 describes certain circumstances when an offeror is not responsible for a prospectus under PR5.5.3

unless the safeguards listed above for the protection of minority investors are implemented and shown to function effectively in practice.

Prospectus

All market participants agree that the current regulatory regime has resulted in prospectuses that are overly large.

We are strongly supportive of the UKLA's aim to reduce the amount of generic information in the prospectus. We encourage issuers, their Sponsors and lawyers to work with the UKLA to provide a document that is more succinct in providing the important information relevant to an investment decision.

Sponsors

Investors do not differentiate between role of the Sponsor and the lead bookrunner(s). They will generally hold the lead bookrunner(s) responsible if a deal goes sour, irrespective of whether they were the formal Sponsor or not.

Whilst the recent changes have conferred a greater regulatory responsibility on the Sponsor, there is a concern that this quasi-regulatory role is limited in its effectiveness. This is because Sponsors are typically one of the lead distributors of an IPO and therefore they may be conflicted if there are any contentious issues with the company. This has raised the possibility of other professional firms such as lawyers and accountants taking on the role of Sponsor.

Independent Advisers

Investors typically have limited contact with the independent advisers as part of the IPO process. However, they value the importance of a well-run syndicate and proper flow of information.

In many cases, particularly on larger or more complicated transactions, independent advisers can play an important role in ensuring that the syndicate is well managed, that the right information and advice is provided both to and by the issuer and that the syndicates and that the issuer's interests are protected.

3. SECONDARY OFFERINGS

The system in the UK for raising new equity capital for already listed companies is fit for purpose.

Particularly during 2008 and 2009, the market for rights issues was considered by all parties to have worked well and helped companies raise equity finance in very challenging circumstances. A big part of this is due to the backing issuers received from institutional investors who played a crucial role in recapitalising "UK plc".

Nonetheless, there are areas that can be addressed with the aim of improving the efficiency of the process and the ability for listed companies to raise equity capital in the London market.

Protecting Pre-Emption

Pre-emption as the cornerstone of this system is a major strength and remains highly valued by investors.

Raising more than 10% of issued share capital for companies listed on the Main Market should always be done on a pre-emptive basis, unless otherwise approved by shareholders for specific reasons in specific circumstances. In any event, raising more than 10% will require a prospectus.

The greater flexibility offered to companies traded on AIM is appropriate.

Greater flexibility in the issuance on a non-pre-emptive basis of up to 10% would be valued by issuers and their advisers. The use of "cash box" structures means that, in practice, such flexibility exists for many companies.

Investors remain concerned about the potentially dilutive effects of non-pre-emptive issues. In all such issues, they attach great weight to being consulted ahead of non-pre-emptive placings and being given the opportunity, in practice, to "stand their corner".

Greater clarity is needed surrounding what is acceptable to investors in relation to non-pre-emptive placings.

Key Recommendations

The ABI will clarify its existing guidance on non-pre-emptive placings, open offers and rights issues.

The Pre-Emption Group should be reconvened with a view to assessing the scope and suitability of their Statement of Principles in the light of market practice.

At least, the revised ABI guidance and Statement of Principles should provide clarity on:

- the limit for placings for cash, including aggregate issuance over a time period longer than one year, and associated discount,
- the limit for vendor placings conducted on a non-pre-emptive basis and associated discount,
- the acceptability or otherwise of the cash box when not used as directly acquisition linked financing,
- acceptable levels of capital raised and associated discounts for open offers,
- the reference price when calculating discounts, and whether fees associated with such issues should be included, and
- the application of such Principles or guidelines for the Standard segment and AIM.

Major existing institutional shareholders should be consulted in advance of non-pre-emptive placings.

Underwriting Capacity, Fees and Discounts

Overall, there is sufficient primary and sub-underwriting capacity in the UK market. However, capacity from the traditional sub-underwriters in the UK has reduced.

There is agreement amongst most parties that the split of risk and the reward for taking such risk between primary and sub-underwriters could be improved.

Deep discount rights issues should be encouraged as a way to lower fees.

There may however be a level of fees where it will be difficult to attract traditional UK institutional sub-underwriters, even if the discount is high and so risk is low. Too low a fee could lead to substantial proportions of a transaction being sub-underwritten with “unnatural” counterparties, or not sub-underwritten at all. Long-only institutions need to balance their desire to see a transaction fully sub-underwritten by “natural” long-term holders with the minimum size of the fee they are prepared to enter in to such sub-underwriting commitments.

It is currently difficult to reconcile the risk to each underwriter and sub-underwriter with the reward they receive because of a lack of transparency of a bundled fee.

An unbundled fee, and transparency on other capital raising associated costs, will enable all parties to reconcile risk with reward, understand the true costs of preparation of the rights issue, and allow greater clarity, where appropriate, in setting the different fees for different roles within the issue.

Tendering for primary underwriting could, in principle, lead to a reduction in fees. However, we believe having the transparency of an unbundled fee is likely in the first instance to introduce a tension that will lead to more competitive primary underwriting fees. Tendering could also lead to a lower desire or ability of the primary underwriters to pass on the risk, because their underwriting fee may be absorbed to an unattractive extent by the fee paid to sub-underwriters.

There is no desire from any party to tender for sub-underwriting. Tendering might in principle bring down fee levels, but at the same time result in a greater proportion of issues being sub-underwritten by unnatural holders.

In order to make the process more efficient, it is likely that more standard sub-underwriting documents, negotiated well ahead of time, should be used. These may have to be negotiated on an institution by institution basis, unless a more general document can be agreed amongst all parties.

For non-pre-emptive placings, it is difficult for the market to see, particularly on a retrospective basis, whether fees are competitive and transactions are being priced appropriately. Greater transparency is therefore needed for the fees and discounts in such transactions.

Key Recommendations

Companies should use deep discounts in rights issues in order to reduce the level of underwriting fees paid to both primary underwriters and sub-underwriters. They are also encouraged to reduce primary underwriting fees where possible by getting firm undertakings from sub-underwriters prior to announcement of the transaction.

The gross spread for rights issues and open offers should be unbundled, such that the amounts for advice, including document preparation, primary underwriting and sub-underwriting are shown separately. These unbundled fees should be fully disclosed in the offering documents, along with disclosure of other rights issue-related fees, including, but not limited to, lawyers, accountants and independent advisers.

There is no legal requirement for the disclosure of disaggregated fees. However, investors would like to see disaggregated disclosure as a matter of best practice

Tendering for both primary and sub-underwriting should be pursued only if the unbundling of fees does not lead to a lowering of the overall fee levels.

We suggest that both buy side and sell side should work to develop standard sub-underwriting agreements. This would help to make the sub-underwriting process more efficient particularly if institutions are engaged ahead of announcement, which in turn should lead to a reduction in overall fees.

The aggregate fees charged and the discounts to the mid-market price at the time of agreeing the placing should be disclosed in the pricing announcement for non-pre-emptive placings.

Timetable

Efforts could be made to shorten a pre-emptive offering timetable further by examining ways to eliminate physical distribution of documents and reducing the time needed by custodians to enact their clients' instructions to exercise.

The UKLA should investigate the feasibility of introducing a fast-track review process for time critical offerings. Issuers should expect to pay higher fees for any extra resources needed for the UKLA to provide this service.

UK Equity Capital Markets – Structure

London is one of the world's leading financial centres and the largest in Europe. It continues to attract a wide range of companies to list on its market. As at April 2013, there were:

- 1,314 companies with a combined market value of £4,345bn listed on the London Stock Exchange's market for listed securities – the Main Market, and
- 1,088 companies with an aggregate market value of £61.6bn quoted on the Alternative Investment Market ("AIM").⁹

London holds this position because of a wide range of factors including:

- the large pool of institutional investors who manage funds in the UK on behalf of both British and international investors,
- the lower cost of capital for companies issuing shares as a result of efficient market structures,
- the high quality of business support available for companies irrespective of size and origin, and
- the stable legal and regulatory regime.

The London Stock Exchange is the main market place for equities in the UK, although there are other recognised investment exchanges, such as BATS Chi-X Europe, ICAP Securities and Derivatives Exchange and NYSE Euronext London, on which companies can have their shares admitted to trading.

Companies choosing to float on the London Stock Exchange may choose between the Main Market and AIM.

There are different routes for joining the Main Market including applying to trade on the Premium, Standard and High Growth segments.

- **Premium** - This is only open to equity shares issued by trading companies and closed- and open-ended investment entities. Issuers with a Premium listing are required to meet the UK's super equivalent rules which are higher than the EU minimum requirements.
- **Standard** - This is open to equity shares, Global Depositary Receipts ("GDRs"), debt securities, and securitised derivatives that are required to comply with EU minimum requirements. A Standard listing allows issuers to access the Main Market by meeting EU harmonised standards. Issuers that later opt to adopt the super equivalent standards can apply to move into the Premium segment.

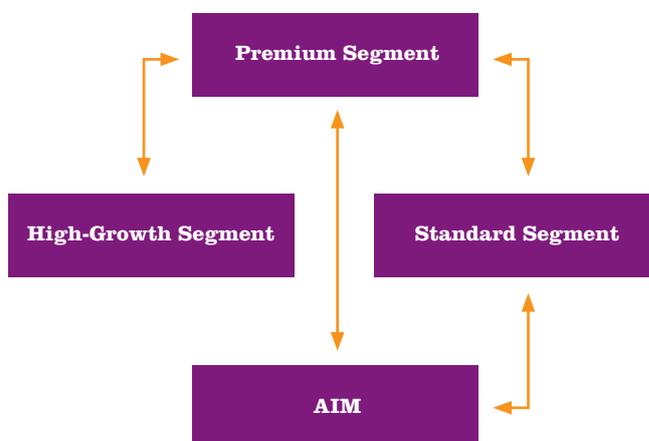
- **High Growth Segment ("HGS")** – This is designed specifically for high revenue growth, trading businesses incorporated in an EEA state that are, over time, aspiring to join the Premium segment. They are subject to the EU minimum standards and the HGS rulebook issued by the London Stock Exchange.

The AIM Market is designed for smaller, growing companies. It is regulated by the London Stock Exchange but it is not a "regulated market" for the purposes of EU financial services regulation. It falls within the classification of a Multilateral Trading Facility ("MTF") as defined under the Markets in Financial Instruments Directive 2004 ("MiFID"). As such, companies listing on this market benefit from more straightforward and less restrictive regulatory compliance requirements in comparison with the Main Market.

Companies initially quoted on AIM can move into the Premium segment by:

- applying to the Financial Conduct Authority ("FCA") to be admitted to the Official List and to the LSE to be admitted to trading in the Premium segment,
- applying to the FCA to be admitted to the Official List and to the LSE to be admitted to trading in the Standard segment and gradually progressing to Premium thereafter,
- merging with another AIM company and relisting as a new entity in the Premium segment, or
- being taken over by a Premium listed company.

Figure 1. Possible ways to move into the Premium segment



The key differences between these segments are highlighted in the table on the next page:

⁹ Source: London Stock Exchange Main Market and AIM Factsheets, April 2013

Figure 2. London Stock Exchange Market Segments

	AIM	High Growth	Standard	Premium
Number of Companies with ordinary shares as at 30 April 2013	1,088	1,314 (Main Market Total)		
Total Market Value as at 30 April 2013	£61.6bn	£4,345bn (Main Market Total)		
Regulation	Multilateral Trading Facility	Regulated Market	Regulated Market (Official List)	Regulated Market (Official List)
Country of Incorporation	Any	EEA State	Any	Any
Sponsor or similar adviser required	Yes – Nomad	Yes - Key Adviser	No	Yes - Sponsor

Eligibility Criteria

Minimum Free Float	Nominated adviser assessment of suitability	10% with a value of £30m	25%	25%
Minimum Market Capitalisation	Nominated adviser assessment of suitability	n/a	£700k	£700k
Audited Historical Financial Information	3 years or such shorter period as applicable	3 years or such shorter period	3 years or such shorter period	3 years
Indices	FTSE AIM series where applicable	n/a	n/a	FTSE UK Series where eligible

Continuing Obligations

Corporate Governance	Expected Market Practice	Corporate Governance Statement and Voluntary application of other Corporate Governance Codes	Corporate Governance Statement Issuer must comply or explain against its national code (if so required by its domestic law) or against a chosen code	UK Corporate Governance Code
Pre-emption Rights	Company Law (Article 29 of Company Law Directive 77/91/EEC for EEA incorporated issuers)	Company Law (Article 29 of Company Law Directive 77/91/EEC for EEA incorporated issuers) ¹⁰	Company Law ¹¹ (Article 29 of Company Law Directive 77/91/EEC for EEA incorporated issuers)	Listing Rule 9 ¹² and Pre-emption Guidelines
Transfer between listing categories	n/a	No approval required when transferring to Premium	No shareholder approval required	75% shareholder approval to transfer out of the category

¹⁰ Article 29: Whenever the capital is increased by consideration in cash, the shares must be offered on a pre-emptive basis to shareholders in proportion to the capital represented by their shares.

¹¹ Companies Act 2006 Section 561 - Existing shareholders' right of pre-emption: A company must not allot equity securities to a person on any terms unless:

- it has made an offer to each person who holds ordinary shares in the company to allot to him on the same or more favourable terms a proportion of those securities that is as nearly as practicable equal to the proportion in nominal value held by him of the ordinary share capital of the company, and
- the period during which any such offer may be accepted [14 days] has expired or the company has received notice or refusal of every offer so made.

¹² Listing Rule 9.3.11: A listed company proposing to issue equity securities for cash or to sell treasury shares that are equity shares for cash must first offer those equity securities in proportion to their existing holdings to: (1) existing holders of that class of equity shares (other than the listed company itself by virtue of it holding treasury shares); and (2) holders of other equity shares of the listed company who are entitled to be offered them.

Initial Public Offerings (“IPOs”)

Over the past decade, there has been an increase in cross-border IPOs. Although many companies have a single, “natural” home, which is likely to dictate where they list, this is by no means true of all. As markets become more international and more IPO centres develop around the world, vendors and issuers have an increasing choice of venue. Key factors affecting a decision of where to list will include:

- likely liquidity,
- likely valuation, often driven by the range of comparable quoted companies, and
- the availability of a more knowledgeable investor base.

Between 2001 and 2011, cross border IPOs accounted for 9% of the volume and 13% of the value of all IPOs in the UK. Although a wide range of listing venues around the world is available, London and New York are by far the largest and attracted 41% and 23%, respectively, of all cross-border IPOs between 2001 and 2011.¹³

For companies that are considering listing in the UK, the most commonly considered alternative is listing in the US. Maintaining a competitive and attractive environment is therefore critical to London’s future as an international financial centre.

Therefore, we highlight the key differences between the requirements for the London Stock Exchange Main Market Premium listing segment and the New York Stock Exchange (“NYSE”) (under which non-US companies may qualify to list).

¹³ Source: PWC, “Equity sans frontières” – Trends in cross-border IPOs and an outlook for the future, November 2012

Figure 3. London Stock Exchange Premium vs. NYSE Domestic and Worldwide

	LSE Main Market with UKLA Premium Listing	NYSE Domestic	NYSE Worldwide
Prospectus	<p>EU Prospectus Directive compliant prospectus and must include:</p> <ul style="list-style-type: none"> • 3 year audited consolidated accounts for at least 75% of the business. • Offer summary, company description, industry overview, risk factors, use of proceeds, description of the security etc. <p>Document must be vetted by the UKLA and takes 10-16 weeks</p>	<p>Registration statement (S-1) filed with the SEC includes the prospectus and is also the central document used to market to investors.</p> <p>Document must include:</p> <ul style="list-style-type: none"> • 3 year historical financials • Offer summary, company description, industry overview, risk factors, use of proceeds, description of the security etc. <p>Document must be reviewed by the SEC and takes 8-12 weeks</p>	
Free Float/ Distribution	At least 25%	<ul style="list-style-type: none"> • 400+ US round-lot shareholders¹⁴, or • 2,200 total shareholders and 100,000 shares monthly trading volume (most recent 6 months), or • 500 total shareholders and 1,000,000 shares monthly trading volume (most recent 12 months) • 1.1m public shares • Market value of at least \$40m 	<ul style="list-style-type: none"> • 5,000 round lot shareholders • 2.5m public shares • Public market value \$100m
Financial Criteria	Minimum Market Cap £700,000	<p>Company must meet one of the following NYSE standards:</p> <ol style="list-style-type: none"> 1) Valuation with Revenues/ Cash Flow <ul style="list-style-type: none"> • Market Cap of \$750m, and • Revenues (in the most recent fiscal year) of \$75m <p>Or</p> <ul style="list-style-type: none"> • Market Cap of \$500m at IPO, • Revenues of \$100m in the last 12 months, and • Aggregate adjusted cash flow of \$25m for the last 3 years. All years must be positive. 2) Assets and Equity <ul style="list-style-type: none"> • Market cap \$150m • Total Assets \$75m • Shareholder Equity \$50m 3) Earnings Test <ul style="list-style-type: none"> • Aggregate pre-tax income for the last 3 years of \$10 million, • Minimum of \$2m in each of the 2 most recent years and the third year must be positive; or • Aggregate pre-tax income for the last 3 years of \$12m, and • Minimum of \$5m in the most recent year and • Minimum of \$3m in the next most recent year 4) Affiliated Company <ul style="list-style-type: none"> • New entities with a parent or affiliated company listed on the NYSE • Market Cap \$500m • 12 month operating history 	<p>Company must meet one of the following NYSE Standards</p> <ol style="list-style-type: none"> 1) Valuation with Revenues/Cash Flow <ul style="list-style-type: none"> • Market Cap of \$750m, and • Revenues (in the most recent fiscal year) of \$75m <p>Or</p> <ul style="list-style-type: none"> • Market Cap of \$500m at IPO, • Revenues of \$100m in the last 12 months, • Aggregate adjusted cash flow of \$100m for the last 3 years • Minimum of \$25m cash flow in each of the 2 preceding years 2) Earnings Test <ul style="list-style-type: none"> • Aggregate pre-tax income for the last 3 years of \$100 million, and • Minimum of \$25m in each of the 2 most recent years 3) Affiliated Company <ul style="list-style-type: none"> • New entities with a parent or affiliated company listed on the NYSE • Market Cap \$500m • 12 month operating history
Corporate Governance	UK Corporate Governance Code – “comply or explain”	<p>More rigorous directors’ liabilities.</p> <p>Sarbanes-Oxley requirements including:</p> <ul style="list-style-type: none"> • a Public Company Oversight Board, • increased corporate responsibility, and <p>Enhanced penalties for fraud and white collar crime.</p>	
Indicies	<p>Eligible for inclusion in main FTSE indices</p> <ul style="list-style-type: none"> • At least 25% free float for UK incorporated companies ; or • At least 50% for non-UK incorporated companies. 	<ul style="list-style-type: none"> • Will need to be domiciled in the US for inclusion in key indices e.g. S&P 500 • Subject to a 6-12 month seasoning period 	

1. IPOs IN THE UK

1.1. Regulatory Regime

The nominated competent authority for listing in the UK for the purposes of Part IV of the Financial Services and Markets Act (FSMA) 2000 is the Financial Conduct Authority. The FCA regulates the Official List and oversees the Listing Rules, Prospectus Rules, and Disclosure and Transparency Rules¹⁵. The London Stock Exchange regulates the Main Market and oversees the Admission and Disclosure Standards.

The regulatory requirements of a company listing on the Main Market of the London Stock Exchange will vary depending on the segment of the market. As the Main Market is an EU regulated market, all companies must produce a full Prospectus to be approved by the UK Listing Authority (“UKLA”) regardless of the segment they are applying for admission to. Other regulatory requirements include:

- Premium – FCA Listing Rules and London Stock Exchange’s Admission and Disclosure Standards.
- Standard – FCA Listing Rules and London Stock Exchange’s Admission and Disclosure Standards.
- High Growth Segment – London Stock Exchange’s High Growth Segment Rules and Admission and Disclosure Standards.

Once a company is admitted to trading, it is subject to ongoing obligations set out in the Listing Rules and the Disclosure and Transparency Rules which apply (although to different extents) to all listed companies.

For a company to be listed on the Premium and Standard segment of the Main Market, it is necessary for it to apply to have its securities:

- admitted to the Official List regulated by UKLA, and
- admitted to trading on the Main Market of the London Stock Exchange.

Admission becomes effective only when all the relevant documents have been approved by the UKLA, and the decision to admit the securities to trading has been announced jointly by the London Stock Exchange and the UKLA.

1.2. Standard UK IPO Process¹⁶

A typical UK IPO process can generally be completed within 15 to 20 weeks, from kick-off meeting until pricing.

This will vary depending on market conditions, the scope and complexity of the deal and a range of other factors. The process involves both, a private and public phase.

Private Phase

During the private phase the company will appoint all its advisers including, for a company to be listed in the Premium segment, the Sponsor. The Sponsor has a number of responsibilities, both to the company and to the UKLA, including submitting drafts of the prospectus to the UKLA.¹⁷

Typically, it takes approximately six to eight weeks from initial submission of the prospectus to the UKLA to receive preliminary approval ahead of launching the transaction, often with a Pathfinder prospectus, an unapproved version of the offering document that can be used as a marketing document to institutional investors. However, this will vary from transaction to transaction.

The company’s advisers will undertake due diligence to ensure the accuracy, truthfulness and completeness of the company’s prospectus and to understand any issues arising.

Although the prospectus is a legal document once approved by the UKLA, it is also used during the marketing period to help sell shares to potential investors. The Sponsor/bookrunner(s) who will be responsible for crafting the appropriate marketing story, also take the primary responsibility for drafting the prospectus with the assistance of the company’s lawyers.

The company’s senior management will meet with the syndicate member’s research analysts around 4 weeks before an intended launch to brief them on the company. Senior management will provide these “connected analysts” with information they require to publish pre-deal research but any material information provided to the analysts must then be included in the prospectus.

Public Phase

The company will provide specific information on its IPO plans in an Intention to Float Announcement (“ITF”). This announcement marks the beginning of the public phase of the IPO. The ITF is preceded by the publication of pre-deal research by syndicate analysts (“connected research”) the night before. At this point, the blackout period begins where there will be no research published by the connected analysts, or analysts relying on anything other than a UKLA fully approved prospectus, up to 40 days post-IPO.

¹⁵ The Prospectus Rules prescribe the form, contents and approval requirements for prospectuses. The Listing Rules and the Disclosure and Transparency Rules apply to companies which have had their shares admitted to listing on the Official List. The Listing Rules set out the eligibility criteria for listing, the continuing obligations of listed issuers (other than those contained in the Disclosure and Transparency Rules) and the sponsor regime. The Disclosure and Transparency Rules set out the regime for disclosure and control of inside information by issuers as well as for notification of interests in shares by directors and certain other senior managers, together with provisions relating to financial reporting and notification of voting rights by major shareholders.

¹⁶ London Stock Exchange (2010), A Guide to Listing on the London Stock Exchange, London Stock Exchange Plc. and White Page Ltd.

¹⁷ See Section 3.6. on the Role of Sponsor.

Connected analysts now begin the investor education process using the research that they have written, introducing the company and its attributes to their clients and the investor base. At the end of the investor education process, the bookrunner(s) and the company agree a price range, based on feedback from investor meetings, within which the offering will be marketed.

At this stage of the process, the Pathfinder prospectus is made available to potential institutional investors. In offerings with a retail tranche, instead of a Pathfinder, a fully approved Price Range prospectus will be distributed. The management roadshow, during which the CEO and CFO will meet a significant number of investors to explain the business, the investment case and the rationale for the IPO, now begins and usually lasts two weeks.

Once the price range has been set, the bookrunner(s) will start taking orders from investors and will begin building a book of demand showing how much interest there is for shares being offered at different prices. The bookbuilding process runs for the full duration of the management roadshow.

At the end of the bookbuilding process and the management roadshow, the company and/or vendor agree with the bookrunners the price of the shares in the offering after considering the book of demand, its price sensitivity, market conditions and other relevant factors. If a fully approved prospectus has not already been published, a final prospectus must be submitted to the UKLA for approval and will include the relevant pricing and offering size information.

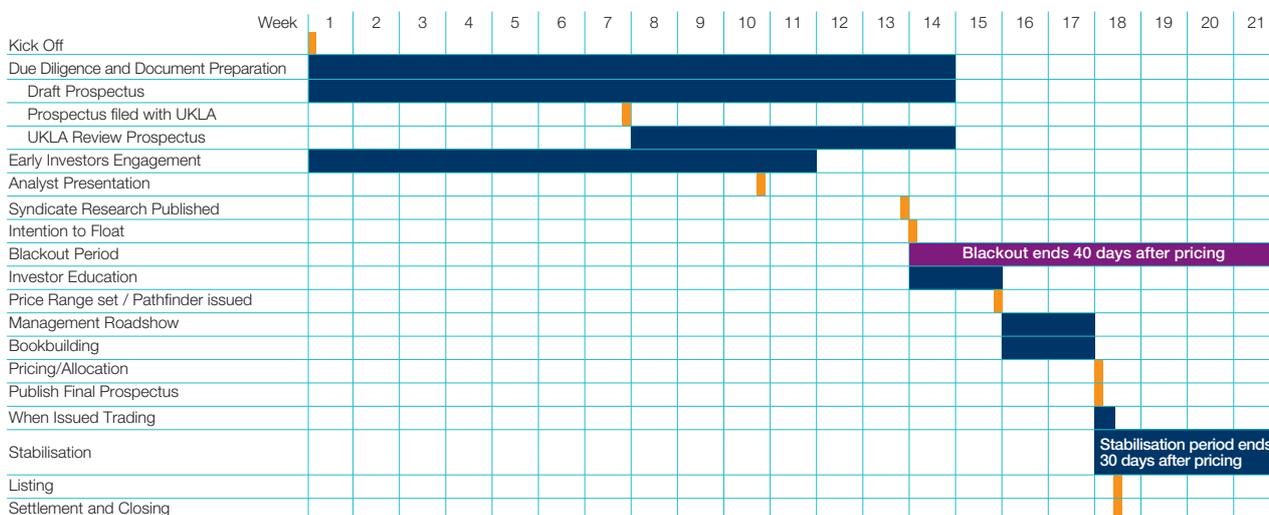
Otherwise a pricing announcement will be made.

The bookrunners and the company then agree on the allocation of the shares and these allocations are confirmed to the investors the following morning, before the shares begin conditional trading.

Closing, or the payment for the newly listed shares, typically occurs three business days after pricing. During this three-day-period, the shares may trade on a “when issued” basis, meaning that the trades are not settled until the listing becomes effective.

The first days of trading of a newly listed company’s shares are often accompanied by high volumes and high volatility as investors with allocated shares in the IPO make further decisions on their position size. If decisions to sell are made by a large number of investors before equivalent buy decisions are made, a destabilising imbalance may ensue. In order to lessen the likelihood of a disorderly market, the lead bookrunner is able, in an operation called stabilisation, to mop up loose shares in the market at or below the issue price, using a short position established by the bookrunner by allocating more shares than originally on offer. To ensure that the lead bookrunner has not made allotments which it cannot fulfil, the vendor/issuer grants the lead bookrunner an option over shares which will cover any remaining short position at the end of the stabilisation period. This mechanism is known as the “Greenshoe” and typically represents 15% of the original offer size. The stabilisation period can operate for up to 30 days if required.

Figure 4. Traditional UK IPO Timetable



2. IPOs IN THE US

The Securities Act of 1933 requires that a registration statement (S-1), which includes the prospectus, must be filed with the Securities and Exchange Commissions (“SEC”) and that it is accepted for filing by the SEC before securities can be sold. Initial filing, and any subsequent filings (S-1A) until registration is effective, are public filings.

After the preliminary registration statement is filed, the SEC comprehensively reviews the document and responds to the company in writing. If revisions are necessary, the company modifies the S-1 as necessary and the SEC declares it effective once they are satisfied.

After the filing has become effective, the comment letters from the SEC and the company’s response are also made publicly available.

In addition to filing the registration statement with the SEC, filings must also be made in the states in which the company intends to offer the securities, as well as with the Financial Industry Regulatory Authority (“FINRA”).

In the period between the initial filing of the registration statement and its effective date (the “waiting period”) the company and underwriters may distribute copies of the preliminary prospectus (the “red herring”). It is during this period that the offering will be marketed to investors by the syndicate and the company’s management will hold meetings with investors.

SEC rules stipulate that the red herring may omit the offering price, underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, or other matters dependent on the offering price.

No research is issued by any analyst connected with any syndicate member (“connected research”) until 40 days after pricing. However, analysts will typically have informal discussions with investors after the price range has been set, without any adverse legal implications for the distribution of shares. Such discussions are not allowed under SEC rules ahead of the publication of the red herring.

The red herring must bear a legend, stating that a registration statement related to the offering has been filed with the SEC but has not yet become effective and that securities may not be offered, nor may offers to buy be accepted before the effective date. Typically, underwriters will orally solicit orders during the waiting period. However, any orders received will be treated legally as “indications of interest”.

The issue is then priced and allocated in a similar way to UK IPOs. Once the SEC has declared the registration statement effective after pricing, the shares can begin to trade unconditionally. Over-allotment and stabilisation also occur in the US.

Companies can also file a “shelf” registration statement with the SEC to register a public offering when they have no immediate intention to sell the securities being registered. A shelf registration can be used for both primary and secondary offerings. This enables an issuer to access the capital markets quickly when needed, or when market conditions are optimal.

The JOBS Act

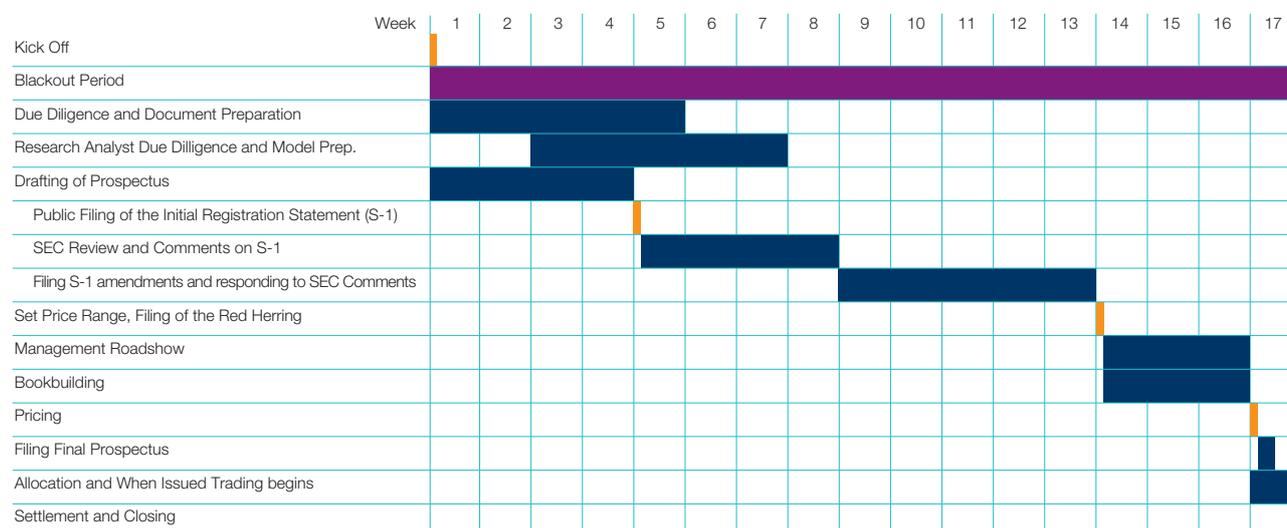
In April 2012, the Jumpstart Our Business Start-ups Act (the “JOBS Act”) was enacted. The law is designed to make it easier for small and growing companies to attract a wide range of investors and access capital while complying with US securities law by reducing the regulatory burden of capital raising and on-going SEC reporting. Specifically, it:

- adopted an IPO on-ramp for a new category of “emerging growth companies” – i.e. companies with annual gross revenue of less than \$1 billion in their most recent completed fiscal year, and
- facilitates the ability of companies to raise capital in private and small public offerings without registering with the SEC.

This offers a number of benefits for emerging growth companies including:

- confidential submission of their draft IPO registration statements to the SEC for non-public review prior to filing them publicly,
- exemption from certain governance and disclosure requirements including auditor attestation for internal controls under section 404 (b) of the Sarbanes-Oxley Act, therefore reducing the costs of compliance,
- no restriction on “pilot fishing”, or engagement with a small number of selected investors in the few weeks before making a decision to launch, with qualified institutional buyers (“QIBs”) and institutional accredited investors to gauge their interest before and after filing a registration statement for any securities offering,
- permitting broker-dealers to issue research reports before, during or after IPOs even if the broker-dealer is participating on the offering,
- permitting general solicitation and advertising for offerings to QIBs and accredited investors.

Figure 5. Traditional US IPO Timetable



2.1. Comparison of the UK and US IPO Process

In the US, initial prospectus filings and any subsequent filings, until registration is effective, are public filings. This means that any potential investors can view the prospectus ahead of the launching an IPO. However, in the UK, all prospectus filings with the UKLA are confidential.

In the US, connected analysts are prohibited from issuing research reports or recommendations before or during an IPO until 40 days after the IPO. As a result there is no investor education ahead of setting the price range in the US IPO process. The price range is therefore set without the benefit of direct conversations with investors about the company that is planning to float. However, in the UK the research is published the night before the ITF and analysts use the research to educate investors ahead of the management roadshow and inform decisions concerning the price range.

However, it is common in the US for the final IPO price to be set outside the price range indicated in the red herring (since the beginning of 2007, more than 60% of US IPOs were priced outside the price range¹⁸). In the UK, pricing outside the initial range is very unusual because of the longer notice period required and the market resistance to such a change. The UK market believes the investor education process used in the UK should have appropriately informed the setting of such a range, so pricing above the initial price range leads to accusations from investors of

excess by vendors or issuers, and pricing below the range leads to the stigma of a poorly received offering.

Another key difference between the UK and US IPO process is with regard to corporate governance. The UK “comply or explain” approach to corporate governance varies significantly from the US method which adopts a rules-based approach enshrined in law by virtue of the Sarbanes Oxley Act 2002 (“SOX”). SOX makes corporate governance and internal control assessment more costly by:

- requiring auditor independence, auditor partner rotations and restricting audit companies from providing non-audit services such as internal audit, legal and valuation services,
- requiring company management to take individual responsibility for the accuracy and validity of financial reports, and
- mandating enhanced financial disclosures including off-balance sheet transactions that require internal controls for assuring the accuracy of financial reports and disclosures. These internal controls must also be audited.

Both NYSE and NASDAQ have defined and published corporate governance listing standards that need to be adhered to and are, in part, in response to SOX. However, the standards go beyond SOX and address other issues such as the approval of related-party transactions for companies quoted on NASDAQ¹⁹.

¹⁸ Source: Dealogic
¹⁹ PWC, Roadmap for an IPO, A guide to going public, 2011

3. KEY ISSUES IN THE UK IPO MARKET

Following the financial crisis, there have been expressions of discontent in the market with regard to the IPO process. Since 2007, the number of IPOs in London has continuously decreased, with a trough in 2009 (although there has been an increase in activity in the first half 2013). This has led to a perception among some commentators that the IPO process in the UK is broken.

Figure 6. Number of IPOs on the London Main Market and Funds Raised



Source: London Stock Exchange – New Issue and IPO Summary

We have found that, on the whole, market participants do not believe that the UK model is fundamentally broken. Rather, the negative perception of the IPO market has prevailed because its health and success relies on confidence and momentum in the wider market. This has been lacking for a number of years (although, again, there has been an improvement in sentiment in the first half of 2013). Nonetheless, there are areas that can be addressed with the aim of improving the efficiency of the process and the attractiveness of the London market, including:

- the information asymmetry that exists in favour of issuers and vendors at the expense of investors,
- the price discovery mechanism,
- the lack of independent research,
- the timetable,
- syndicate sizes,
- the allocation process,
- fees,
- free float and corporate governance,
- prospectus size,
- the role of Sponsor, and
- the use of independent advisers.

3.1. Information Asymmetry/Price Discovery

An information asymmetry exists in favour of issuers and vendors at the expense of investors.

It is crucial that the IPO process addresses this imbalance to ensure that investors can understand the investment case and value the asset appropriately.

There is currently not enough time in the formal IPO period, post the announcement of an ITF, to address the imbalance sufficiently.

A healthy price discovery process is far more likely to lead to a sustainable price post listing.

The IPO process starts with a very substantial information asymmetry between the issuer/vendor and the investor. The whole of the process should be designed to help rectify this imbalance through education of the investors as to the drivers of the business, the issuer's positioning within a sector or market, finding out more about the management team and the issuer's key attributes as to why it will make a good investment for any purchaser.

Intermediaries provide the bridge between issuer and investor to facilitate this transfer of information and ultimately to enable both buyers and sellers to find a valuation at which the transaction will clear. This transfer of knowledge is at the heart of the IPO process and key to a successful IPO.

During the public phase of the IPO, once the ITF has been released, a typical timetable for an IPO will involve two weeks of investor education conducted by the analysts of the syndicate banks, followed by the publication of a Pathfinder or Price Range prospectus and a two week roadshow conducted by management (see Figure 4).

Over this period, a typical investor will have spent an hour or two with one or more syndicate analysts and an hour with company management, plus some time for their own analysis, after which they are expected to make an investment decision.

This compares with a significantly greater amount of time and analysis that an investor will spend on companies that are already listed and for which there is a much more even balance of information and a substantially greater history already in the public domain. It is therefore unsurprising that investors have a desire to increase the amount of time they have to analyse the company coming to market.

Time itself, however, is not the crucial issue. It is what is done with that time and what information is available that is key.

Early engagement with issuers

The concept of “pilot fishing”, or engagement with a small number of selected investors in the few weeks before making a decision to launch, has been around for almost a decade. Pilot fishing is important in assessing overall sentiment towards an issue and helpful in gaining market feedback on possible pricing.

However, investors have been very clear that they want to meet companies up to a year or more before a potential IPO in order to gain familiarity with the business and the drivers of profitability, establish a relationship with the management that will enable them to build a record with investors and begin to formulate a sense as to what will be the key valuation measures that investors should use.

Issuers, vendors and advisers have all stated that they find the ability to engage with investors early very helpful in developing the investment case, preparing the company and management for the public market, establishing a more realistic valuation expectation of all parties and helping investors hit the ground running once the formal part of the IPO process is reached.

Some investors have expressed a concern that early engagement can be used as a stalking horse for a sale to a third party, as part of a dual track process, but most consider that, so long as there is genuine openness during this engagement, it is perfectly reasonable for a vendor to engage with all parties who might have an interest in buying the asset before establishing the best path.

The role of pre-deal research and availability of non-connected research

Investors have stated that, while they generally find the connected research useful for background and as preparation for the arrival of the prospectus, they are almost universally sceptical of its independence, despite the regulatory changes that have taken place in the post-Spitzer environment and the care that investment banks’ compliance departments take in its preparation.

Most investors say they would like to see more non-connected research, written by independent research analysts, as they feel this would act as a balance to the connected research. They reject a fear expressed by issuers, vendors and investment banks that independent

research will always be biased to the negative. Investors say they would not reward, and might even penalise, independent analysts who wrote research which was negative without having the appropriate justification, and that they would, and do, reward positive and balanced independent research as much as negative, if valuable to their investment decision.

From an issuer or vendor perspective, they have some control over the timing and factual accuracy of connected analyst research. They may have concerns that independent research that has not been checked for factual accuracy and which has been produced at a different time in the lead up to an IPO, could disrupt the roadshow process.

Most sell-side banks, advisers and lawyers are not opposed to having more independent research per se. However, they are against it if there is a chance that it could either jeopardise the ability to distribute the offering in certain jurisdictions (the predominant problem being the US) or if it might create potential liabilities either for themselves or the issuer.

The UK and European IPO process differs from the US in that it allows the use of pre-deal research, or research that is published ahead of the ITF and the prospectus. However, even for UK IPOs, connected research (and any other research not written solely using a prospectus fully approved by the UKLA) still cannot be distributed into the US, as it would otherwise remove the ability to distribute shares in the US without incorporating the research into the offering document. The research is therefore only relevant to UK and European investors.

Independent analysts have two potential methods of gaining access to significant information about the issuer:

- The first is via the analysts’ presentation that the syndicate analysts attend some weeks prior to the ITF, or a similar presentation arranged at a different time just for independent analysts (during the recent Crest Nicholson IPO, for example, independent analysts were invited to a separate presentation by management two days after the ITF). If they attend this, it is likely that they will have to sign up to “Research Guidelines” which will restrict their distribution of their research.
- The other is via the Pathfinder prospectus which is published at the start of the bookbuilding process during offerings solely to institutions. However, independent research providers are in practice unable to publish research based on the Pathfinder. This is because:

the Pathfinder is a marketing document distributed to institutional investors during an offering. It is not approved by the UKLA (unlike a stamped Price Range prospectus which is issued during offerings with a retail tranche). Given this, the syndicate will usually impose legal restrictions, as a condition of making it available, on the ability of any third party to place reliance on it or quote or reproduce any information contained in it, and

- in any event, if the analyst has not attended any management presentation earlier in the process, it may in practice be difficult to generate considered research in the time available.

Price discovery

The current IPO timetable from the time of announcement is shown in Figure 4.

The three key decision points in the IPO process are:

- the decision to launch (the ITF),
- the setting of the price range, and
- the final pricing.

These are all based around one concept – valuation. The determination of valuation, or price discovery, is therefore an extremely important part of the process. Yet it is something that is often an area of contention between all parties.

All parties believe that early engagement helps establish a valuation range, but, before the ITF, detailed information on the company is typically scarce unless there is a public bond issue in the market or the company has previously disclosed its financials. Pilot fishing appears to have become more useful in recent years as it has developed from an opportunity for management to practice their presentation skills with a rather uninformative slide pack, to a genuine discussion of the merits of the company. Connected research is helpful in beginning to build a picture of the company, and independent research would help this further.

However, it is the prospectus that really enables investors to build good financial models and form an accurate opinion of valuation. Unfortunately:

- investors' feedback to the bookrunners on valuation at the end of the investor education process, which is used to help the vendor, issuer and advisers set the price range, is not made with full information as they will not have seen the Pathfinder (or Price Range) prospectus at this point, and

- even for meetings that take place after the Pathfinder is published (i.e. after T+14 in the outline timetable in Figure 4), many investors find that they have barely received it in time for their meeting with management, reducing their ability to have a full discussion and extract maximum value from the meeting.

The IPO timetable and the research blackout

Investors are currently unable to receive the prospectus until an "appropriate" amount of time has passed since the publication of the pre-deal research, to provide a degree of separation between the two:

- the separation has been required on legal advice going back to the 1980s. The legal risk that gave the rise to the perceived need for a blackout period is that, by giving research analysts access in advance to non-public information in the form of a draft prospectus, or an invitation to the analyst presentation, their research may be seen as a product of the company. Therefore, it might be considered to be part of the offer document. If so, this means that the company may be liable for the content of the analysts' research and potentially require the research to be included in the prospectus,
- market practice has developed over many years such that the standard separation time is now around two weeks, down from three months in the 1980s, with a minimum of about eight days.

However, in France, a substantially complete offering document, the French language "document de base", is published on the l'Autorité des Marchés Financiers (the French market regulator, the "AMF") website at the time of the analysts' presentation, some weeks before connected research is published. So there is no separation between publication of a French offering document and connected research. Despite the main financial and operational details of the company being already available, and even though no marketing is conducted by the company of this information, a blackout period is still retained between the publication of connected research and the English language prospectus.

All parties we have consulted, including lawyers, now believe that meaningful separation in time should not be viewed as essential. Provided other steps are taken to preserve the independence of research and its separation from company marketing materials, it should be acceptable to issuers and banks (from a liability perspective) to publish the prospectus with little or no time delay after the release of the research. Investors could then receive the definitive disclosure document earlier in the process.

This would enable a change in the timetable that we believe will bring benefits to investors, underwriters, vendors and issuers.

It is still, however, perceived that issuers and underwriters theoretically have a potential liability on the basis that investors, particularly in the US, despite not receiving research, might make their investment decision on the back of the research or might use the existence of contemporaneous research as a basis for alleging the prospectus was misleading. There is precedent for legal action by retail investors in the US against issuers and banks in US registered offerings. However, as far as we are aware, there is none by institutional investors based in the US in offerings sold under Rule 144A, which is the usual exemption to SEC registration used in the distribution of UK IPOs into the US. The risks therefore seem minimal.

Because it is impossible to conclude legally, in current circumstances, that no risk exists, issuers' and underwriters' internal counsel are reluctant to forego the protection offered by the market practice of separation of research and the offering document. The blackout period therefore persists.

Assistance in reducing these risks further would encourage issuers' and underwriters' internal counsel to reconsider the necessity of the blackout.

Conclusions

Early engagement, many months ahead of an IPO, between investors and issuers is seen by all parties as an excellent way of beginning the process of addressing the information asymmetry that exists between issuers and vendors on the one hand and investors on the other.

While connected pre-deal research is still seen as valuable by investors, they believe it is important to increase the ability for non-connected independent analysts to access information and publish research before pricing.

Publishing the prospectus earlier in the IPO process will enable investors to be better prepared for the management roadshow and to give more incisive feedback on the company and its valuation ahead of setting a price range, therefore improving the price discovery process for all parties.

If the prospectus is published early and fully approved by the UKLA at this point, there is likely to be more published independent analysis ahead of pricing.

However, in order to achieve this, there is a need to eliminate

the market practice of separating pre-deal research and the prospectus – the initial part of the research blackout period. The barrier to this lies in persuading issuers' and underwriters' internal counsel that the risks of having legal action taken against them by institutional investors, either in the UK or the US, are minimal.

Regulatory clarification that there is no need to separate pre-deal research from the publication of the prospectus will help in this aim and help achieve:

- earlier publication of the prospectus,
- improvements in the price discovery process and a price range more likely to result in a successful IPO, and
- a reduction in the overall length of time that the IPO is "in the market", thereby reducing the risk of failure due to market volatility. The time that the price range is in the market could also be shortened.

Key Recommendations

We encourage the practice of early engagement by issuers and vendors with investors up to a year or more before a planned IPO. This should be seen as an integral part of the IPO process.

Investors should ensure that the appropriate resource is committed to such early engagement, even - or particularly - when the IPO pipeline becomes very busy.

A prospectus approved by the UKLA, which is complete apart from pricing or price range and related information, should be issued at least one week earlier than the Pathfinder or Price Range prospectus is issued in current practice:

- this will require eliminating the delay between publication of connected research and the offering document.
- It should be achieved by obtaining regulatory clarification from the FCA that:
 - they will not regard connected research, if prepared and identified appropriately, as part of the prospectus,
 - publication close to the time of the prospectus will not necessarily compromise its independence (in the sense that it is independent of the company), and
 - therefore temporal separation between connected research and prospectus publication is unnecessary²⁰.
- This should eliminate any residual UK risk for issuers and underwriters and it will, as a matter of evidence, reduce the likelihood of any successful action in jurisdictions outside the UK.

²⁰ This is likely to require clarification of the FCA's Conduct of Business Rule 12.2.12G.

As a result, the typical timetable for an IPO, once the ITF has been made, could be shortened by one week, from four to three weeks (although it could remain longer for a particular issue if desired). A typical timetable might therefore be as follows (T+/- in days):

- T-1 – Publish pre-deal research on the eve of the ITF,
- T – Release the ITF,
- T to T+1 – Publish approved prospectus,
- T to T+13 – Investor education by syndicate,

- T+7 – T+21 – Management roadshow,
- T+14 – Supplementary prospectus published with price range or price range announced via RIS,
- T+14 – T+21 – Bookbuilding,
- T+22 – Final supplementary prospectus published with price or price announced via RIS, and allocations made. “When issued” trading begins.

For illustrative purposes and comparison, a typical IPO timetable and the proposed timetable are shown on the below.

Figure 7. Standard IPO Timetable

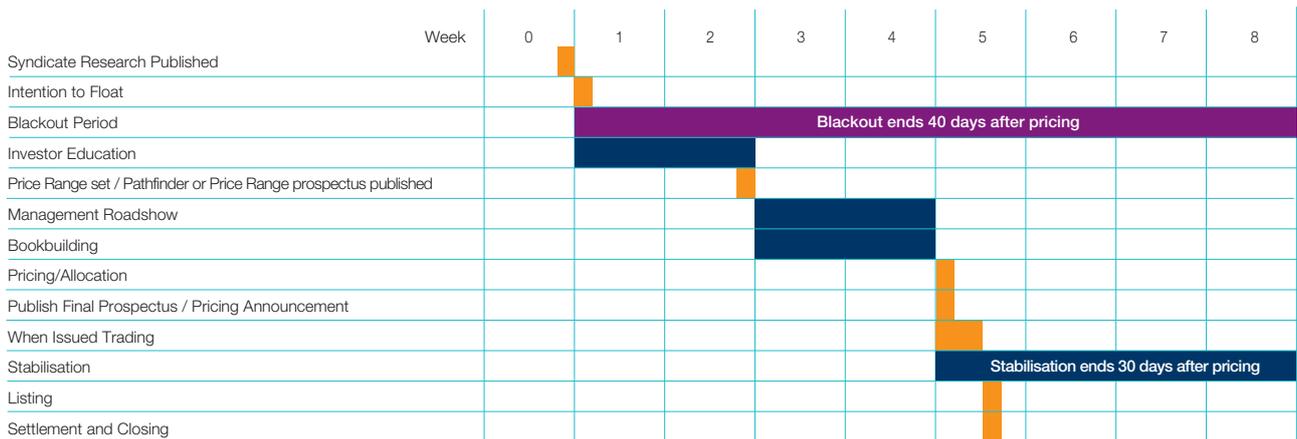
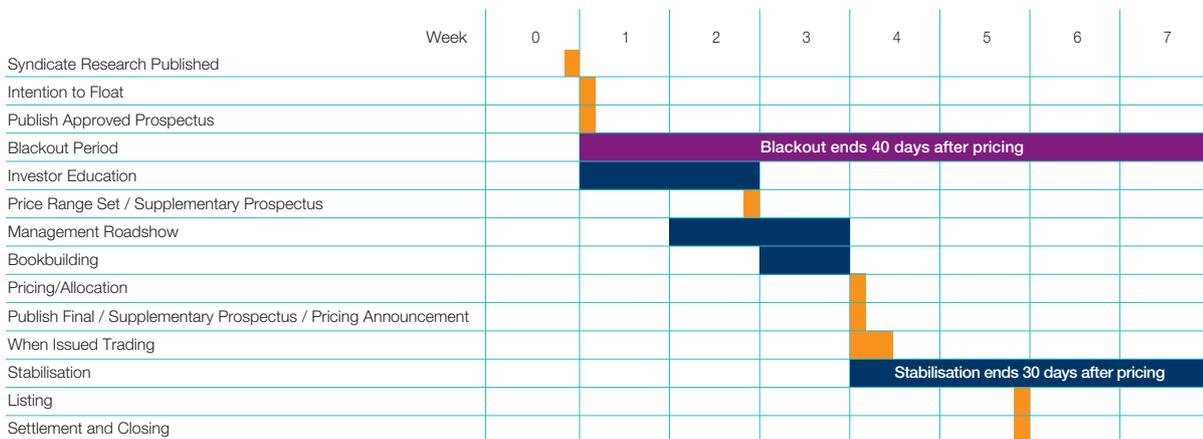


Figure 8. Proposed IPO Timetable



The IPO process should allow at least one of two alternatives to promote the publication of independent research:

1. Issuers and underwriters should allow greater access for non-connected analysts to the IPO analysts' presentation or a subsequent similar presentation, such that they are able to have the same information as connected analysts:
 - if a company were to grant access to unconnected analysts without them agreeing to factual accuracy checks, the company would likely insist on certain other undertakings already agreed to by connected analysts, including distribution restrictions,
 - the regulatory clarification by the FCA mentioned above will mitigate risks that companies may be liable for the content of such research.

2. Alternatively, non-connected analysts should be able to publish and distribute research with reference to a prospectus published immediately after the ITF that has been fully approved by the UKLA:
 - the Prospectus Rules do not require a price range or an offer price for shares to be included for the prospectus to be stamped,
 - the prospectus containing all the required disclosures on the issuer and its business could therefore be published, with no price or price range in it, at the ITF stage,
 - the price range could be fixed by the publication of a supplementary prospectus at a later stage. The final offer price could be fixed by the publication of a pricing supplement at the completion of the bookbuild process,
 - this approach is currently possible and requires no change in law or regulation.

3.2. Syndicates and Distribution

A syndicate of banks provides the required access and distribution to an investor base which will ultimately make up a stable shareholder register for the company undergoing an IPO.

For the efficient delivery of this aim, the syndicate needs to maintain a balance between achieving depth of distribution to a wide range of investors and avoiding duplication of investor opinion from across and within the various investor categories.

Investor categories may be split by type (e.g. retail, institutional, high net worth) or region (e.g. London,

Scotland, other UK regions, Europe, US, Rest of the World).

There is a concern amongst a number of investors and independent advisers that too few IPOs in the Premium segment contain any form of retail participation. Despite the allocation to institutions being reduced, they see the involvement of retail as providing stable ownership on the share register.

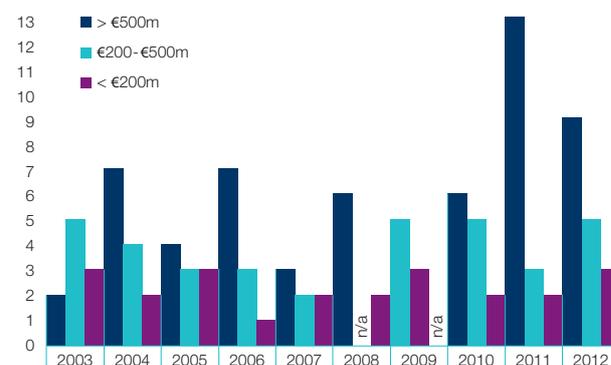
Accessing retail investors in UK offerings can be done via either:

- directly via an Offer for Subscription or Offer for Sale, a method which was commonly used in the 1980s and 1990s, particularly in the large UK privatisations, or
- via a less burdensome Intermediaries Offer, where retail clients must have an account with an intermediary involved in the offering.

Investors believe that vendors and issuers too often reject the inclusion of retail through either method as burdensome and expensive and will only consider it if the issuer is seen as a consumer brand. Recent examples of successful IPOs involving an Intermediaries Offer are esure Group plc and Direct Line Group plc, with both companies well known to consumers.

Almost all parties believe that syndicate sizes are generally too big and could deliver the desired aims with fewer banks or brokers involved. While in continental Europe large syndicates are sometimes driven by the need to cover a number of key countries or regions with different distribution needs, it is not clear why this should generally be the case in the UK, given that it is a single country with a relatively homogeneous institutional investor base. Some investors even went so far as saying that a large syndicate was a warning on the type of company being brought to market.

Figure 9. Average Syndicate Size in UK IPOs (number of syndicate members)



Source: Dealogic

Explanations given for the increase in total syndicate size include:

- vendors/issuers use the IPO process as an opportunity to pay their advisers for past advice for which they have not been compensated, or because they need to maintain relationships, particularly lending relationships,
- banks that offer financing leverage this relationship with the issuer or vendor to be included in the syndicate in a senior position. Lending banks increasingly seek ancillary fees,
- banks strive to be included in syndicates, regardless of the size of the syndicate, to ensure they do not miss out on league table credit,
- a larger syndicate can help ensure a stronger marketing message, in the case of larger, more complex companies and better presentation of the investment case. This may in part include a desire amongst some issuers, vendors and advisers to limit negative comment on the transaction by non-connected analysts,
- some independent advisers believe that a larger syndicate will help drive better demand and price tension and argue that small syndicates result in bad price discovery. They add:
 - large syndicates, when properly managed, allow banks to focus on their smaller investor clients and reduce the focus on the largest institutional investors,
 - focussing on the tail of investors helps to create momentum around the book building process, particularly as the large institutional investors typically submit their orders towards the end of the book building process.

Some independent advisers also say that a larger syndicate is more likely to deliver a deeper variety of opinion from investors. They argue that opinion cannot then be misrepresented to issuers/vendors by the lead banks to suit their own purposes. They collate all the feedback provided to the different banks by investors including their intention to buy which provides them with an accurate estimation on price. They argue that this is important because, without an independent adviser, banks are unlikely to share this information with each other.

Accessing retail investors either directly or via an Intermediaries Offer is likely to demand a larger syndicate than an offer solely to institutional investors. However, IPOs aimed at attracting a significant retail component have, as stated above, been less common.

Problems that are perceived to result from larger syndicates include:

- a lack of responsibility among syndicate members for bringing unsuitable companies to the market and for poor aftermarket performance, and so a lack of clarity amongst investors as to which bank or broker should be

held accountable on behalf of their fellow syndicate members for the success or failure of a transaction,

- a perceived lack of discipline, leadership and responsibility in the IPO process,
- a lack of clarity amongst the syndicate banks on their respective roles and responsibilities,
- a breakdown in communication between the issuer and potential investors,
- a lack of balanced advice, because banks are less willing to ask issuers the difficult questions or deliver tough messages,
- limiting the independent research available by conflicting a large number of respected analysts, which can stifle a more balanced view of the transaction,
- too many banks calling investors to get feedback on the investment case, pricing and to generate orders,
- lower quality feedback to the company on pricing,
- an inefficient bookbuilding and allocation process,
- lower net fees per bank that do not motivate some banks sufficiently to work in the best interests of the issuer,
- some banks may add no value to the process.

Overall, nearly all investors, investment banks and lawyers, as well as most independent advisers believe that the disadvantages of large syndicates substantially outweigh the advantages and would welcome a move towards smaller syndicates.

Issuers are aware of the downside of large syndicates. They recognise that larger syndicates are harder to manage. However, some independent advisers have said it is difficult to convince their clients to reduce the size of the syndicate due to the multifaceted relationships that the issuers have with their banks.

Equally, private equity vendors acknowledge that banks offer them a wide range of services, including sourcing and financing new deals. Therefore, maintaining these relationships is more important to them than having a smaller syndicate. Nonetheless, they will seek to ensure that all members of the syndicate are valuable in the process.

Allocation

Allocation is a critical part of the IPO process. A core of stable long-term shareholders is considered important both for the longer-term benefit of the issuer and in helping to ensure a stable aftermarket. Poor allocation can lead to high and destabilising turnover of shares in the first few days of a transaction, often several times the size of the shares on offer.

However, there is a risk of conflicts of interest arising because, for example, syndicate members may want to “reward” certain investors who are themselves important clients.

Investors are keen that the issuer is involved in the allocation process to ensure that the shares are distributed in the first instance to those who are most likely to remain long-term shareholders of the company.

Independent advisers can also be helpful in providing independent oversight to the allocation process.

Conclusions

Investors, issuers and vendors are principally concerned with an IPO process that addresses efficiently:

- the information asymmetry,
- price discovery, and
- distribution of the shares and the establishment of a stable shareholder base.

An efficiently functioning syndicate is crucial to addressing these concerns.

Although there are reasons that seem to explain the creation of large syndicates, it is not clear that in the UK this is additive to the process.

The strong preponderance of opinion is in favour of smaller syndicates. There is widespread support to reign in the general increase in syndicate size that has occurred over the last decade.

However, where appropriate, it would be helpful to include an ability to access retail investors for IPOs of companies listing in the Premium segment, and syndicate members that are necessary to achieve this.

Key Recommendations

As a rule of thumb, no more than three bookrunners should be appointed for large transactions, which we suggest is above £250m excluding any over-allotment option. Below this issue size, there should generally be no more than two bookrunners.

Issuers should ensure that any additional members of the syndicate are additive to the process due to their sector expertise or distributional reach.

We discourage the inclusion of syndicate members who are present solely on the basis of past or future services to the issuer or vendors.

Nonetheless, we acknowledge that vendors and/or companies may from time to time need to appoint more banks to the syndicate due to on-going relationships. In these instances, companies should specify clearly to each syndicate member their roles and responsibilities. This could include an entirely passive role on the transaction.

Issuers, with the assistance of independent advisers if appropriate, should scrutinise the allocations carefully to ensure that shares are being distributed to those most likely to be long-term shareholders.

We encourage issuers and vendors to consider including a retail tranche when listing in the Premium segment.

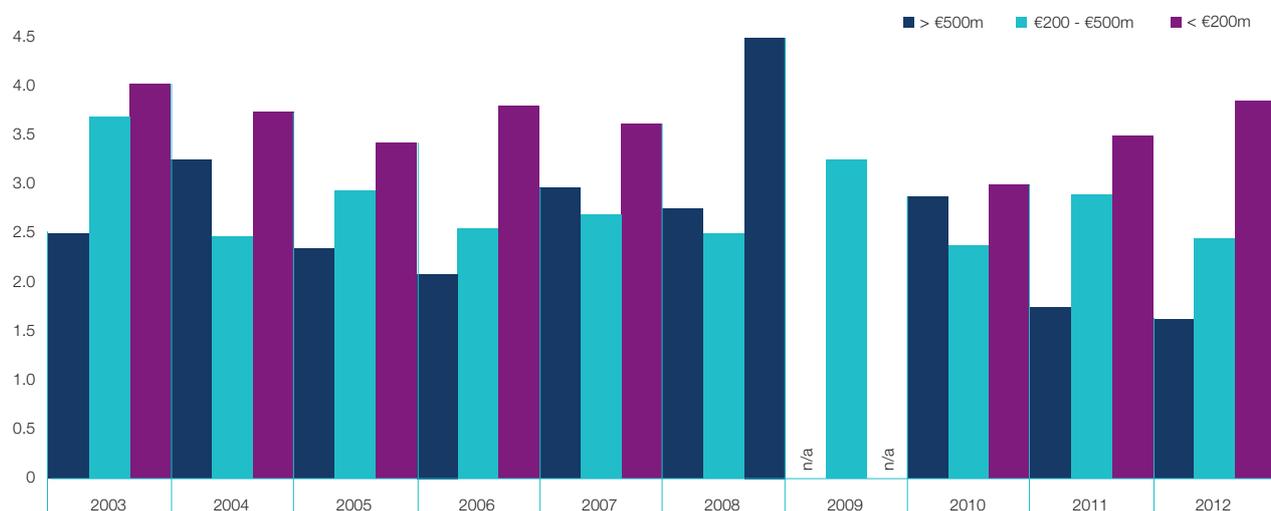
3.3. Fees

IPO fees in the UK vary widely depending on a number of factors, such as size of issue, size of company, identity of vendor, complexity of the transaction, likely breadth of distribution, and desirability of mandate.

A typical fee for a FTSE 350 company is in the range of 2.5% to 3.5% of proceeds, although very large issues are likely to attract fees significantly lower than this. Fees often have a base element, payable upon completion of the offer, and a discretionary or incentive element, with a typical split of 2/3 to 1/3 base to incentive.

This is much lower than in the US, where fees are more typically in the range of 5% to 7% for a transaction of similar size.

Figure 10. Average UK IPO Gross Fees (% of issue size)



Source: Dealogic

Both the fixed and discretionary fees are paid across the syndicate i.e. not only to the lead banks. However, there have been instances where only the bookrunners were paid the incentive fee.

While some investors believe that the level of fees in IPOs is too high, others consider the fees for an IPO to be a matter of concern only for the issuer and/or vendor. Some of the latter investors will nonetheless treat with caution an issuer who has agreed to a fee that the investor believes to be too high, as this may be indicative of their ability to negotiate in future transactions.

Some investors suggested that fees should not be paid as a percentage of offering size, but as an absolute amount.

There is no standard for the disclosure of fees in offering documents. Sometimes a percentage fee as an underwriting commission is shown and then an additional monetary amount for other expenses, and sometimes a total bundled figure for all fees and expenses. What is typically not shown is a breakdown of who is receiving what. This leads to an inability to assess the level of fees and compare with similar transactions.

Unlike in the US, there is no requirement for disclosure of the syndicate members' underwriting amounts. Therefore, the fees accruing to each of the individual syndicate members cannot be calculated.

There is a perception among investors that large syndicates are increasing the size of fees. However, banks stated that fee levels have not increased to reflect the increase in syndicate size. Rather, this has resulted in a reduction of net fees per bank in a large syndicate and has led some to conclude that members of the syndicate, including the bookrunners, not being appropriately motivated.

Incentive Fees

Discretionary fees are typically paid 30 days after the IPO, although there have been instances where the incentive fee has been paid up to six months after the IPO.

The criteria to determine the incentive fee payable tend to include:

- market timing judgements,
- the success of addressing the information asymmetry,
- cooperation amongst the syndicate,
- achieving set timelines and milestones during the documentation phase,

- transparency and utility of feedback to the company, and
- an overall sense of whether the IPO has been a "success".

Incentive fees are occasionally linked to the valuation achieved at IPO. However, linking incentive fees to price performance in the aftermarket creates an incentive for the syndicate that could lead to a breach of the market abuse rules.

It has been proposed that some of the metrics for the incentive fee should be dependent on:

- absolute and/or relative aftermarket performance of the stock,
- volume of trading in the aftermarket on a 3, 6 or 9 months' basis, and
- an assessment of the quality of follow-up research to ensure continued coverage of the issuer after the IPO has been completed.

Investors believe that the earliest an IPO can be judged as a success or failure is after the market price has settled post listing, full research coverage has begun and the market has the chance to compare what was said during the IPO process by the issuer with its first set of results as a listed company.

In the past, syndicate members were paid through "designations", a system whereby institutional investors would indicate to the bookrunners to which bank the selling commission attached to their allocation of shares would accrue. This system was discontinued as investors became frustrated by the substantial lobbying from members of the syndicate in their quest to secure designations. There was also a concern from investors that a designation away from the bookrunners could lead to a lower allocation in this or subsequent IPOs.

Although investors promoted the move away from fee designations, they are now concerned that the current fixed fee structure does not incentivise banks enough. It has been proposed that allowing investors to indicate who has been most helpful during the IPO process may provide a better incentive for banks. This could be done on an anonymous basis through the investor relations team of the newly listed company which would avoid potential pressure from the banks' sales forces.

Conclusions

Although fees at IPO are in effect paid by the issuer, vendors or existing pre-IPO shareholders (with new investors able to take account of overall costs in the price they are prepared to pay), new investors at IPO retain a significant concern with the overall level of fees. Greater

transparency of the composition of the fees paid to all parties at IPO will help address this concern.

There is no legal requirement for the disclosure of disaggregated fees. As the disclosure requirements are contained in the EU Prospectus Directive, which is a maximum harmonisation directive, it is not feasible to change primary legislation or regulations in the UK to require such disclosure. However, investors would like to see disaggregated disclosure as a matter of best practice.

Investors would like to have some ability to influence the award of incentive fees to create a degree of alignment in the assessment of the success of the transaction between them and issuers, vendors and the sell-side.

Such success should be measured over a period of longer than a few days after pricing. Some elements of the incentive fee will only become evident once the company has released its first set of results as a listed company.

Key Recommendations

There should be, as a matter of good practice, greater disclosure in the prospectus of all the fees paid for an IPO, including the maximum incentive fee, if any. This should include a breakdown of fees as a percentage of the size of the offering, and those fees that are independent of size, such as, but not limited to, independent advisers', lawyers' and accountants' fees. Syndicate members' individual fees should also be disclosed.

The final determination and payment of incentive fees in an IPO should be made at the later of the release of the first quarterly results of the issuer as a listed company and three months after listing. The amount paid should be disclosed to the market at the time of award.

The following criteria should be taken into consideration when awarding the incentive fee:

- the stability of the share price in the newly listed environment,
- the allocation of the shares of the issuer to a predominantly long-term shareholder base, as evidenced by the stability of the share register in the aftermarket,
- the extent and quality of the syndicate research both, during and after the IPO in the eyes of the investors, and
- the continuity of research coverage post IPO.

A mechanism should be re-established for investors to give input into the allocation of the incentive fee, but on an anonymous basis.

3.4. Free Float and Corporate Governance

Free float is a key area of debate between all parties.

The current minimum of 25% for a Premium or Standard listing is seen as a barrier to listing on the UK Main Market by vendors, investment banks and independent advisers. It is seen by many sell-side banks and vendors as being one of the most important reasons to choose a US listing as opposed to a UK listing, because it limits flexibility. This is of particular concern because of pricing issues, as described below.

The FSA/FCA has recently consulted over these issues and is proposing a number of changes which include:

- imposing two of the current six Listing Principles on all listed companies and having a set of separate Premium Listing Principles,²¹
- strengthening the corporate governance requirements of all listed companies with controlling shareholders, but in particular for Premium listed companies, including the requirement to have an independent Board.
- They propose a dual voting structure whereby independent directors of Premium listed companies with controlling shareholders must be approved by both the shareholders as a whole and the independent shareholders.
- There is recognition that the controlling shareholder can overrule the minority shareholders if the second round of voting is set at a simple majority of 50%. However, a significant vote against by minority shareholders and the resulting reputational risk to the company and its directors will focus the mind of independent directors to ensure that they are acting in the best interest of the minority shareholders,
- allowing the 25% minimum free float, which should not include shares that are in lock-up for a period of greater than 30 days, for Premium listed companies to drop to 20% if there are more than 100 public shareholders on the register and the value of the free float is greater than £250m. Only in exceptional circumstances would the UKLA allow a free float for a Premium listed company to be below 20%. This is a clarification of the current regime in operation,
- removing the minimum free float level for Standard listed companies, provided there is sufficient liquidity, as determined under existing guidance,
- requiring, for Premium listed companies, a relationship agreement between controlling shareholder and the company, for this to be publicly available and for any material changes to be put to a shareholder vote, and

²¹ Principle 2 requires a listed company to take reasonable steps to establish and maintain adequate resources, systems and controls to enable it to comply with its obligations. Principle 6 requires a listed company to deal with the FCA in an open and co-operative manner.

- requiring the above to be continuing obligations of the company.

The FCA is expected to publish the results of its consultation in the near future.

In this area, it is important to separate three concerns:

- liquidity and pricing,
- index eligibility, and
- governance.

Liquidity and pricing

Investors want to see a flow of high-quality, well-prepared and well-run companies coming to the market. Many continue to see liquidity as an important element in this.

Vendors, sell-side banks and lawyers have stated that a minimum free float on listing of 25% has driven or is driving a number of transactions to list in other jurisdictions where the free float requirements are not as high.

The US exchanges address liquidity by defining criteria, such as number of holders, monetary value and numbers of shares, that it considers will provide sufficient liquidity even at low free float levels, rather than by percentage of capital floated at IPO:

- NYSE Domestic market requires a minimum of 400 round-lot shareholders and NYSE Worldwide requires a minimum number of 5000 round-lot shareholders²². NASDAQ requires a minimum of 400 round-lot shareholders. However, all IPOs in the US have a retail element where the number retail shareholders will be substantially higher than the number of institutional holders. The minimum shareholder numbers therefore do not constitute a material constraint,
- On NYSE the minimum market value of publicly held shares is between \$40m - \$100m, whilst on NASDAQ, it is between \$8m and \$20m depending on listing standard,
- Transferring these numbers into the UK environment is not likely to be appropriate, because of the very different market structure, including low retail participation, but a minimum number of investors at IPO may encourage greater liquidity.

The pricing of an IPO will generally be at a discount to perceived “fair value” i.e. the price at which a parcel of shares, without any premium for control or discount for

illiquidity, might be expected to trade between a willing buyer and a willing seller in prevailing market conditions (although perceptions of what fair value is may, of course, differ between buyer and seller). The larger the amount required to be floated, the greater the value likely to be forgone by the vendor to get the issue away successfully.

Whilst vendors understand the need to price a transaction at a discount (because of the information asymmetry), they will often not want to sell a larger amount at this discount. Indeed, they are likely to be more flexible on pricing if selling a smaller amount.

The Standard segment is generally seen as a less attractive venue by both vendors and issuers, and investors. The former do not want to use a Standard listing because of the likely lower valuations, and the latter do not like it because of the lower standards of corporate governance. In particular, unlike those in the Premium segment, companies in the Standard segment do not have to adhere to the UK Corporate Governance Code, Model Code or other safeguards surrounding acquisitions and related party transactions.

There may of course be an option to float either on AIM or on the London Stock Exchange’s new High Growth segment of the Main Market. However, AIM is unlikely to be suitable for the larger companies because of the limited investor base. Some investors do not invest in the AIM market because it has lower corporate governance standards, or third party mandates limit their ability to invest.

The High Growth segment is also targeting only a small section of potential IPO candidates.

Investors recognise these concerns. However, the majority of investors still believe that 25% should be the minimum free float level for Premium listed companies to provide appropriate liquidity.

Index eligibility

It is important, in addressing investors’ concerns surrounding liquidity at low (less than 25%) free float levels for Premium listed companies, that there is no FTSE index inclusion i.e. there needs to be a clear separation of the criteria for index inclusion from regulatory free float requirements.

FTSE has recognised this and amended their index inclusion criteria to require a minimum free float of 25%.

²² Round-lot shareholders hold a 100 share block, see Figure 3 for more information.

This separation means that there is no need for index-tracking funds to buy shares in a particular company unless a minimum free float of 25% has been achieved.

Governance

All investors would like the corporate governance surrounding controlling shareholders of companies to be tightened.

Investors are broadly supportive of the FCA's proposals in relation to governance in CP12/25²³.

A number of both sell-side and buy-side parties, as well as advisers, agree that an additional safeguard against controlling shareholders would be to require controlling shareholders to take responsibility for certain specified statements in and contents of the prospectus. This is a requirement in the US and forces a greater degree of responsibility on them. Vendors who are frequent issuers in the US have said that they would not find this particularly onerous.

In addition, controlling shareholders who are party to the relationship agreement could have a direct regulatory responsibility to the UKLA for complying with the terms of that agreement, rather than relying on the issuer to enforce its rights under the relationship in contract law.

Another corporate governance concern for investors is the number of IPO candidates who appoint their independent Board members very late in the IPO process. The FCA has considered and rejected requiring companies to appoint Boards at least six months ahead of IPO. Vendors have stated that, because there is always the chance of an IPO failing, they like to retain the option of appointing a fully independent Board relatively late in the process, as undoing such appointments in the event of failure can be cumbersome and detrimental to the control of the company if it remains in private hands.

Conclusions

There is strong support from all parties to strengthen the corporate governance standards of companies with controlling shareholders. This would include imposing certain compliance responsibilities directly on controlling shareholders.

Investors' concerns about weak corporate governance in the Standard segment are likely to be exacerbated if the free float is lowered from the current minimum without raising the protection for minority investors to levels that exist currently in the Premium segment. Any lowering of free float in the Standard segment might attract more issuers, but is unlikely to attract more investors to match such issuance unless corporate governance standards are raised.

The recommendations of CP12/25 in relation to independent Boards and relationship agreements should be followed through.

Controlling shareholders should be required to take responsibility for certain specified statements in and contents of the prospectus and to have responsibility to the UKLA for compliance with the relationship agreement.

Additional responsibilities on controlling shareholders are likely to be helpful in focussing their attention on the disclosure and nature of their relationships with the company and minority shareholders. Discouraging controlling shareholders who are not willing to take on such liability from listing on the London market is a good outcome for the quality of companies that list here.

Some investors would consider a lower free float level requirement in the Premium segment than the current minimum of 25%, if governance were strengthened as outlined above, subject to meeting the minimum liquidity required under Article 48 of CARD²⁴.

However, the majority of investors still believe that 25% should be the minimum free float level for Premium listed companies.

The sell-side is supportive of lowering the free float minimum in both Premium and Standard segments.

We recognise the need to balance the desire of investors to have an independent Board in place well before an IPO and that of the private owners to retain control in the event of a failed flotation.

²³ FSA Consultation Paper CP12/25 (Oct 2012): Enhancing the effectiveness of the Listing Regime and feedback on CP12/2

²⁴ CARD: Consolidated Admissions and Reporting Directive. Article 48, para 5. A sufficient number of shares shall be deemed to have been distributed either when the shares in respect of which application for admission has been made are in the hands of the public to the extent of a least 25 % of the subscribed capital represented by the class of shares concerned or when, in view of the large number of shares of the same class and the extent of their distribution to the public, the market will operate properly with a lower percentage.

Key Recommendations

Controlling shareholders should have liability for the prospectus at IPO for companies seeking a Premium listing. This would cover:

- a controlling shareholder or shareholders acting in concert with holding(s) of 50%+1 pre-IPO. The threshold should be set at this level because, in a private company, the shareholders are not as dispersed as in a public company where 30% is taken as the usual level of de facto control,
- any pre-IPO shareholder who will be party to a relationship agreement post-IPO.

The UKLA would need to identify those acting in concert on a case by case basis when considering eligibility for listing.

Controlling shareholders should:

- be required to include a responsibility statement in the prospectus covering certain statements included in the prospectus regarding future conduct of the business, including their future relationship with the company. This will require a change to Chapter 6 of the UKLA Listing Rules,
- have liability based on the current US model where, broadly, they can be held liable to the same extent as the issuer unless they can establish they acted in good faith and did not directly or indirectly induce the acts of the issuer constituting the violation.²⁵

The FCA is also able to amend PR5.5.3²⁶ (and to limit the scope of PR5.5.7²⁷) to provide for controlling shareholders to be persons responsible for certain content of prospectuses in a wider range of circumstances and so to implement these changes.

A relationship agreement should be required between controlling shareholder(s) and the company. This should include a contractual obligation on the controlling shareholder(s) to comply with the statements included in the prospectus for which they have accepted responsibility. It should be publicly available and any material changes put to a shareholder vote. In addition, the controlling shareholder(s) should have a direct regulatory responsibility to the UKLA for adherence to the provisions of the relationship agreement:

- the UKLA's statutory power to sanction breaches of the Part 6 rules is contained in s91 FSMA 2000²⁸. There is no statutory authority for fining or censuring shareholders of issuers for breaching Listing Rules,

- the UKLA would therefore require additional regulatory authority through primary legislation (an amendment to FSMA 2000) in order to allow it to make Listing Rules that impose obligations on controlling shareholders and to enforce those rules directly.

There should be a phased appointment of independent directors in the months leading up to the IPO. An independent Board should be in place at the latest one month ahead of announcing the intention to float. The requirement for an independent Board should be a continuing obligation once the company is listed under the Listing Rules.

The minimum free float for Premium and Standard listings should be maintained at 25%. The majority of investors will not contemplate a reduction in the free float for Premium listed companies unless the safeguards listed above for the protection of minority investors are implemented and shown to function effectively in practice.

3.5. Prospectus

All market participants agreed that the current regulatory regime has resulted in prospectuses that are overly large.

Views include that prospectuses:

- are too detailed to be understood by retail investors,
- contain too many generic or boiler plate risk factors that obscure the most important risks and opportunities, and
- are too time consuming to go through, given:
 - the blackout period, and
 - the short time between the Pathfinder prospectus being issued and investors' meetings with management as part of the roadshow. Consequently, some investors often feel ill-prepared for the company meeting.

Although there are provisions in the EU Prospectus Directive to allow an abridged version of the full prospectus, this is not used in practice because of concerns by banks and issuers that it creates extra work and, potentially, increased liability risk because of insufficient disclosure if distribution is made into the US.

Many investors feel that a prospectus is not available early enough in the IPO timetable for them to be able to build their models and prepare ahead of meetings with management on the IPO roadshow. The release of the Pathfinder also does not enable non-connected research analysts to publish research during the IPO process.

²⁵ Section 15 and section 20(a) of the US Securities Exchange Act of 1934

²⁶ Prospectus Rule PR5.5.3 describes who is responsible for the prospectus in an offering of equity shares

²⁷ PR5.5.7 describes certain circumstances when an offeror is not responsible for a prospectus under PR5.5.3

²⁸ Financial Services and Markets Act 2000

Some parties on both sell- and buy-side have suggested that it would be helpful to allow forward-looking statements, such as revenue and profit forecasts within the IPO prospectus. However, others, particularly lawyers, believe that the potential to create substantial liability risk for issuers and underwriters, and the potential for abuse by “loading” the figures, would make this impractical and potentially toxic.

Concerns have also been raised that the process is driven by precedent rather than ensuring that the information, particularly the risk factors, contained in the prospectus are company-specific. This is increasing the number of generic risk factors that are included, many of which are arguably irrelevant, and contributes to the increase in size of the document.

Key Recommendations

We are strongly supportive of the UKLA’s aim to reduce the amount of generic information in the prospectus. We encourage issuers, their Sponsors and lawyers to work with the UKLA to provide a document that is more succinct in providing the important information relevant to an investment decision.

3.6. Role of Sponsor

The Listing Rules require that any company seeking a Premium listing of equity securities must appoint a Sponsor. The Sponsor regime is fundamental to ensuring the effectiveness of the Premium equity market by:

- considering whether an issuer is suitable for admission and that admittance will not be detrimental to investors’ interests,
- ensuring that issuers seeking a Premium listing understand the regulatory framework that they operate within, and
- providing the UKLA with assurance that the relevant rules have been complied with and that the issuer has established appropriate procedures and therefore meets the UKLA’s eligibility criteria.

As such, the role of the Sponsor includes the following responsibilities:

- co-ordinating and project managing the IPO process,
- developing the investment case, valuation and offer structure,
- co-ordinating the due diligence and prospectus drafting and reviewing process,
- managing communication with the London Stock Exchange and UKLA, and

- acting as adviser to the company’s Board.

The UKLA reviewed the regime in 2012 and reinforced the role of the Sponsor. The new changes:

- require Sponsors to acknowledge that they have regulatory duties to the FCA under the Listing Rules that cannot be overridden,
- require a Sponsor to be appointed prior to any communication with the FCA in connection with a Sponsor service, and
- oblige Sponsors to provide the FCA with any explanation or confirmation it may reasonably require to ensure that the Listing Rules are being complied with.

Although there is a formal requirement to appoint a Sponsor and the responsibilities are clearly laid out by the FCA, there are differing perceptions amongst market participants as to what it means to be a Sponsor in an IPO.

Investors do not differentiate between role of the Sponsor and the lead bookrunner(s). They will generally hold the lead bookrunner(s) responsible if a deal goes sour, irrespective of whether they were the formal Sponsor or not.

Some advisers argue that, although the Sponsor’s role is principally to provide confirmation that certain processes have been carried out, it should also include providing the Sponsor’s institutional “stamp of approval” of the suitability of the company for listing.

Other advisers believe that the extra amount of work required and the increased reputational and regulatory risk it entails is not commensurate with the additional fees they receive for the role.

Whilst the recent changes have conferred a greater regulatory responsibility on the Sponsor, there is a concern that this quasi-regulatory role is limited in its effectiveness. This is because Sponsors are typically one of the lead distributors of an IPO and therefore they may be conflicted if there are any contentious issues with the company. This has raised the possibility of other professional firms such as lawyers and accountants taking on the role of Sponsor.

The UKLA maintains a list of approved Sponsors and conducts supervisory activities in order to ensure that the list of Sponsors contains only those firms that meet certain eligibility criteria. Sponsor supervision is distinct from FCA’s supervision of authorised firms and is specifically focused on ensuring Sponsor firms discharge their responsibilities under the listing regime. Therefore, it is possible for an

accounting or legal firm to be accredited with Sponsor status by the FCA even though they are not an authorised firm.

However, if accounting firms were increasingly to take on this role, we would expect that different firms would take on the role of Sponsor and reporting accountant. It would not be desirable to have the same firm take on both roles – or at the very least effective safeguards to ensure appropriate separation of functions would be needed.

Issuers seeking a Standard listing do not require a Sponsor.

Issuers that are seeking a flotation on AIM must appoint a Nominated Adviser (“Nomad”) who will be responsible for guiding the issuer during the admission process and ensuring adherence to the AIM rules throughout its life on AIM. This differs from the Sponsor in a Premium listing who only has responsibility for and during the listing process. However, if the Sponsor is a bookrunner (as opposed to an independent adviser), they are often appointed as corporate broker after the listing process has been completed. Issuers, who are seeking to list on the High Growth Segment, must appoint a Key Adviser who plays a similar role to a Sponsor in relation to admission. The Key Adviser should already be an approved Sponsor under the UK Listing Rules.

3.7. Role of the Independent Adviser

In recent years, there has been an increase in the use of independent advisers (“IAs”) in IPOs.

IAs are typically appointed by management teams or vendors who have limited – or at least less frequent - experience of equity capital markets or require extra resource to help them through the process. The role of IAs is to:

- help vendors and issuers address any potential conflicts that their lead managers and syndicate may have,
- consult on and challenge the advice vendors and issuers receive from the syndicate, and
- help manage the overall IPO process.

The IAs may assist in a number of areas, including:

- selection of bookrunners and other advisers,
- fee negotiation,
- assessing valuation,
- preparation of the analysts’ and management presentations alongside the lead managers,
- advising on deal structure,
- setting the price range and assessing demand, and
- allocation at the end of the bookbuilding period.

Investors typically have limited contact with the IAs as part of the IPO process. However, they value the importance of a well-run syndicate and proper flow of information.

There are a number of views amongst other market participants on the reasons for the increased use of IAs and the value that they add to the IPO process. It has been argued that the role of IAs has become increasingly important due to:

- mistrust between banks and issuers/vendors,
- a lack of feedback on investor views,
- a lack of transparency in the bookbuilding process, and
- banks having multiple streams of business, including market making and broking. This can give rise to a conflict of interests in an IPO, particularly on share allocation (as described on p 38).

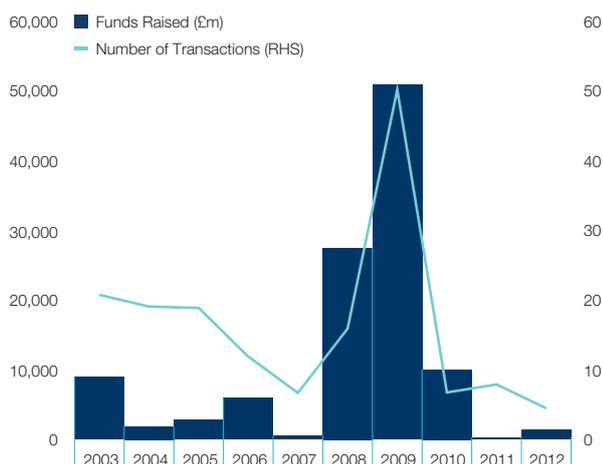
Investment banks, perhaps unsurprisingly, are less enthusiastic about the role that IAs play, stating that some IAs adopt an unnecessarily confrontational approach and can be disruptive to the smooth running of the IPO process.

However, in the light of the range of issues referred to above, we believe that, in many cases, particularly on larger or more complicated transactions, IAs can play an important role in ensuring that the syndicate is well managed, that the right information and advice is provided both to and by the issuer and that the syndicates and that the issuer’s interests are protected.

Secondary Offerings

During the financial crisis, a large number of companies raised finance principally through rights issues.

Figure 11. London Main Market - Number of Rights Issues and Amounts raised



Source: London Stock Exchange – Further Issues Summary

Particularly during 2008 and 2009, the market for rights issues is considered by all parties to have worked well and helped companies raise equity finance in very challenging circumstances. A big part of this is due to the backing issuers received from institutional investors who played a crucial role in recapitalising “UK plc”.

1. METHODS OF SECONDARY OFFERINGS

Rights Issues

A rights issue offers existing shareholders the opportunity to buy further shares, typically at a discount to encourage subscription, in accordance with their pre-emption rights as per s561(1) of the Companies Act 2006.²⁹

Each shareholder's entitlement will be represented by a nil-paid right, which is a tradable security.

Investors in UK quoted companies are protected from the dilution of their ownership stake by these pre-emption rights. The system allows for the equal treatment of all shareholders and even shareholders who do not take up their entitlement to new shares are able to monetise the value of their entitlement through the sale of their nil-paid rights, or by receiving their pro-rata share of the placement of unsubscribed shares.

Usually, the company enters into an underwriting agreement with investment banks, acting as primary underwriters, ahead of announcement. This guarantees that the company receives the funds that they require. The investment banks upon (or even before) announcement seek to lay off most or all of their risk to sub-underwriters, who have traditionally consisted of existing shareholders and other UK institutional investors.

One of the most important aspects of a rights offering is setting the terms and the price of the new shares. Typically, they are offered at a significant discount to the market price prior to announcement. In the 1980s, the discount generally used to be between 15% and 20% to the Theoretical Ex-Rights Price (“TERP”), which is the price of the shares immediately prior to announcement adjusted for the dilution caused by the rights issue³⁰. This has changed over the recent years and more UK companies have undertaken rights issues at deeper discounts (around 30% to 40% to the TERP).

Under the EU Prospectus Directive, a prospectus will be needed for a rights issue, if more than 10% of the existing share capital is being raised.

The bank(s) advising the company receives a bundled fee for their advice, preparation and underwriting, a portion of which they pay to the sub-underwriters.

A typical rights issue timetable is shown in Figures 13 and 14.

²⁹ Also stated in LR 9.3.11

³⁰ Example calculation of TERP: Two new shares are being issued for every three existing shares held (a “2 for 3” rights issue). If the share price prior to announcement was 500p, and the new shares were priced at 250p, then the TERP is calculated by adding the total cost of the shares already owned (3x500p) to the cost of the new shares that the investor is entitled to (2x250p), and dividing that sum by the total number of shares now owned post rights issue (3 old + 2 new). Therefore the TERP is (1500+500)/5 = 400p. In this example, the discount to TERP is therefore 20%.

Open Offers and Placings with Clawback

An open offer is a quicker way of raising funds than a rights issue. It is, like a rights issue, a pre-emptive offer to the existing shareholders to purchase additional shares in proportion to their shareholding, but there is no mechanism to allow them to sell their nil-paid entitlement to the new shares. Any entitlement not taken up by a shareholder lapses.

Open offers are used less frequently than rights issues because of the inability to monetise the entitlement and therefore the unavoidable dilution to those investors unable to subscribe for new shares. Because of this:

- UKLA Listing Rules set a maximum discount for the new shares of 10% to the mid-market price at the time of announcement of the terms of the offer³¹. This applies to companies with a Premium listing but does not apply to companies with a Standard listing or UK companies traded on AIM.
- the ABI has a preference for rights issues over open offers if more than 15-18% of share capital is being raised and/or the discount exceeds 7.5%.

Shares are placed with investors (“conditional placees”), who effectively act as sub-underwriters, “subject to clawback” by existing shareholders. If the open offer is fully subscribed, the conditional placees will not receive any shares; if it is partially subscribed, they receive shares pro-rata to their conditional placement.

Open offers are often used in conjunction with a firm placing when, ahead of the announcement, some of the existing shareholders have committed not to take up their entitlement. These shares are then placed on a firm basis with new investors alongside shares placed subject to clawback.

The firm placing element is therefore a way of recycling new shares from existing shareholders unable to subscribe to new shareholders at the time of announcement, providing stability during the offer period. The share price would be likely to suffer greater volatility if this overhang of stock were left until the end of the subscription period, potentially jeopardising the success of the issue.

In the same way as rights issues, the issuer typically will enter into an underwriting agreement with investment bank(s) which will be paid a fee for advice, preparation and underwriting. The conditional placees will be paid a fee by the banks for effectively sub-underwriting the issue.

A prospectus will be required for an open offer of more than 10% of share capital.

Placing for Cash

A placing for cash requires disapplication of pre-emption rights. If a company wishes to disapply pre-emption rights, it must seek approval from existing shareholders.

Shareholders are routinely willing to permit Premium listed companies to issue non-pre-emptively up to 5% of shareholder capital in any one year, subject to a maximum of 7.5% in any rolling three year period (Statement of Principles by the Pre-Emption Group, which is supported by the ABI, NAPF and IMA). Companies listed on AIM are also encouraged to apply the guidelines.³²

No prospectus is required, under the EU Prospectus Directive, to the extent that less than 10% of capital is issued in any one year. Placings for cash are typically made off the back of a Regulatory Information Service announcement (“RIS”).

Retail investors are, subject to some limited exemptions, not able to subscribe for these placings as there is no prospectus.

The Pre-Emption Group’s Statement of Principles does not consider discounts greater than 5% to the price at announcement, including expenses directly relevant to the making of the issue, as routine. However, under UKLA Listing Rules, the maximum discount for a placing of a Premium listed company’s shares is 10% to the prevailing mid-market price at the time of agreeing the placing.³³

Vendor Placing

A vendor placing is a placing directly linked to an acquisition where the consideration for the acquisition is shares issued to the vendor. These shares are then placed on a non-pre-emptive basis to investors and the proceeds are paid to the vendor.

Under UKLA Listing Rules, the maximum discount for a vendor placing is 10% to the prevailing mid-market price at the time of agreeing the placing.³⁴

ABI guidelines on pre-emption rights and vendor placings state that issues involving more than 10% of equity share capital or a discount greater than 5% should be placed on a basis which leaves existing shareholders with a right to claw back their pro-rata share of the issue if they wish to do so.

However, vendor placings with clawback are not common. More usually, vendor placings are used to raise less than 10% of equity capital, without a prospectus.

³¹ LR9.5.10R (1): If a listed company makes an open offer, placing, vendor consideration placing, offer for subscription of equity shares or an issue out of treasury (other than in respect of an employees’ share scheme) of a class already listed, the price must not be at a discount of more than 10% to the middle market price of those shares at the time of announcing the terms of the offer for an open offer or offer for subscription of equity shares or at the time of agreeing the placing for a placing or vendor consideration placing.

³² Pre-Emption Group, Disapplying Pre-Emption Rights, A Statements of Principles: 5. The principles set out here relate to issues of equity securities for cash other than on a pre-emptive basis pro rata to existing shareholders by all UK companies which are primary listed on the Main Market of the London Stock Exchange. Companies quoted on AIM are encouraged to apply these guidelines but investors recognise that greater flexibility is likely to be justified in the case of such companies.

³³ LR9.5.10R (1): If a listed company makes an open offer, placing, vendor consideration placing, offer for subscription of equity shares or an issue out of treasury (other than in respect of an employees’ share scheme) of a class already listed, the price must not be at a discount of more than 10% to the middle market price of those shares at the time of announcing the terms of the offer for an open offer or offer for subscription of equity shares or at the time of agreeing the placing for a placing or vendor consideration placing

³⁴ Ibid.

Cash-boxes

The “cash box” is a vendor placing construct where up to 10% is raised on a non-pre-emptive basis using the vendor placing methodology within a series of financial companies not directly linked to the purchase of any particular asset. It was initially developed as an alternative to a vendor placing so as to enable the vendor of an asset to the non-pre-emptive issuer of shares to receive the consideration in cash, rather than take delivery of shares for onward placement.

Originally, the capital raising was linked to an acquisition. However, over the last decade, it has become relatively common to use the cash box structure as a method of circumventing the Pre-Emption Group’s Statement of Principles restricting placings for cash on a non-pre-emptive basis to 5%/7.5%. Instead of being used for the immediate financing of a specific transaction, the placing might be loosely connected to an acquisition at an

unspecified time in the future, or plans for a potential acquisition or pipeline of acquisitions. In some cases, it has been used for general corporate purposes.

Given that vendor placings do not fall within the limits for cash placings under the Pre-Emption Group’s Statement of Principles, there is no formal limit as to the number of such cash box placings that can be done over any time period, save restrictions determined by already authorised share capital and the requirement that any issuance over 10% in any calendar year will require a prospectus under the EU Prospectus Directive.

The average discount to the preannouncement price for placings of shares of less than 10% of capital over the last 10 years (placings for cash and vendor placings including cash boxes) is around 3.9% excluding fees³⁵. There is no data available on fees or discounts to the mid-market price at the time of agreeing the placing.

Figure 12. Comparison of Rights Issues, Open Offers and Vendor Placings

	Rights issue	Open Offer and Vendor Placing with clawback
Offer Structure	<ul style="list-style-type: none"> • Pre-emptive offer to existing shareholders • Includes detachable, tradable nil-paid rights to subscribe for newly issued shares • Unsubscribed rights are sold, post subscription period, in a “rump placing” • Shares not placed in the rump placing are then taken up by the sub-underwriters (the “stick”) 	<ul style="list-style-type: none"> • Newly issued shares are placed, typically with a mix of new holders and existing holders • A portion of the shares are sometimes “placed firm” which allows new investor to participate with certainty • The remainder of the shares are placed “conditionally”, or “subject to clawback” • Existing holders are then given the option to participate in the offer and “claw back” shares
Offer Metrics	<ul style="list-style-type: none"> • Typically a discount to TERP of around 30% to 40% • Large discount results in a significant number of new shares issued 	<ul style="list-style-type: none"> • Discounts to prevailing price of up to 10% • Tighter discount leads to lower portion of company sold
Pros	<ul style="list-style-type: none"> • Fully pre-emptive • Cash compensation for rights not followed • Simple, well understood structure with numerous precedents • Shareholders can execute a “tail swallow” by selling rights to fund new share purchases and remain cash neutral 	<ul style="list-style-type: none"> • Partially pre-emptive (assuming some firm placing) • New shareholders introduced • Allows issuer to build demand up front • More flexibility • Shorter timetable than rights issue
Cons	<ul style="list-style-type: none"> • Uncertainty over levels of sub-underwriting • Would have to be offered at a substantial discount • Relies on existing shareholder support • Longer timetable than open offer 	<ul style="list-style-type: none"> • New shareholders must be identified • Dilutive for those shareholders unable to subscribe pro rata share • No tradable entitlement
Options for Shareholders	<ul style="list-style-type: none"> • Take up rights <ul style="list-style-type: none"> • number of rights taken up at, the discretion of the shareholder, up to the holder’s allotted pro-rated amount • if full rights are taken up, shareholding in enlarged Company is undiluted • Sell nil-paid rights • Ignore rights to new shares <ul style="list-style-type: none"> • shareholder paid value of nil- paid rights at end of rights period • shareholdings diluted 	<ul style="list-style-type: none"> • Take part in conditional and/or firm placement • Take up entitlement to new shares in whole or in part • Ignore rights to new shares - shareholdings diluted
Acceptances	<ul style="list-style-type: none"> • Remaining shares are placed to institutions in a “rump placement” • Stick left with sub-underwriters 	<ul style="list-style-type: none"> • Non-accepting shareholders do not receive any compensation for the loss in value arising from the dilution • Shares not subscribed for are left with the conditional places

³⁵ Source: Dealogic

2. TIMETABLE OF A TYPICAL RIGHTS ISSUE

A typical timetable for a rights issue in the UK may take eight to 12 weeks from the kick-off meeting. This is dependent on whether a general shareholder meeting will be required to disapply pre-emption rights and the time needed for the preparation of the prospectus.

Figure 13. Overall Timetable (with EGM)

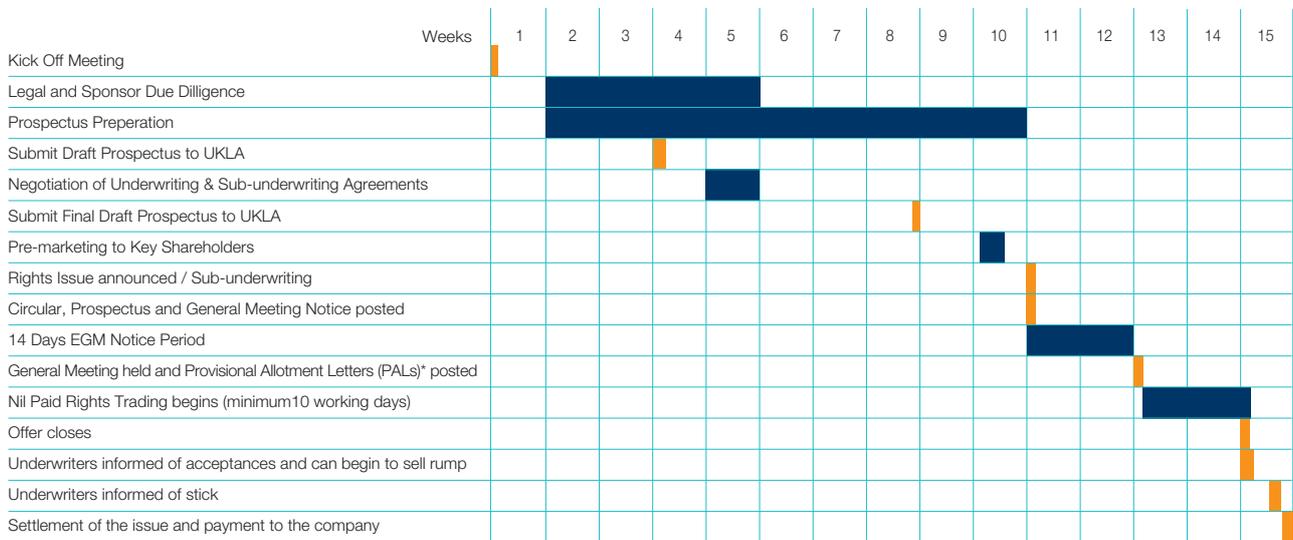
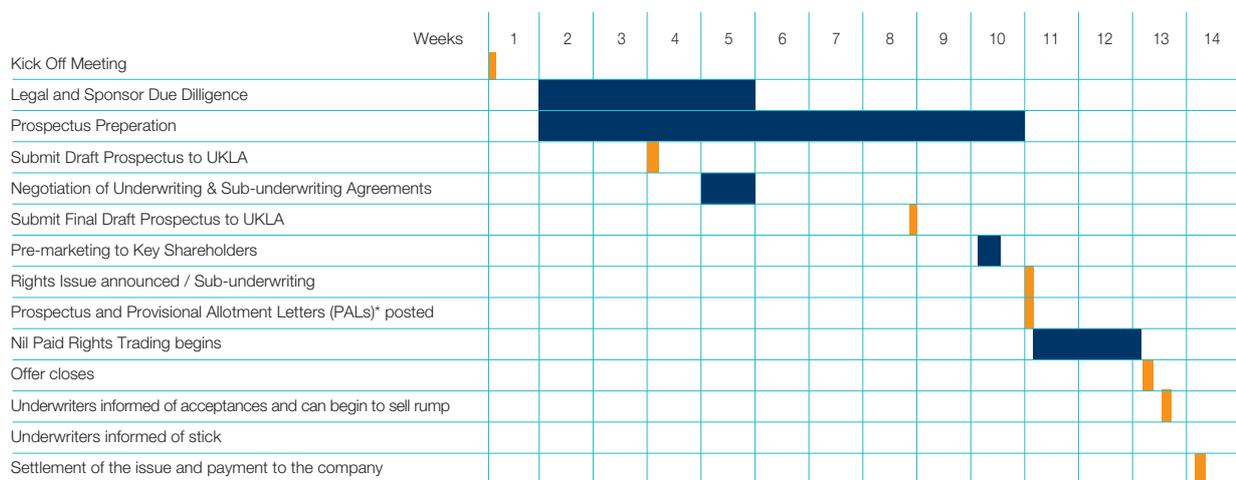


Figure 14. Overall Timetable (without EGM)



*PALs give shareholders the right to subscribe for shares under the issue and they can sell this right in the market nil paid.

3. FEE TRENDS

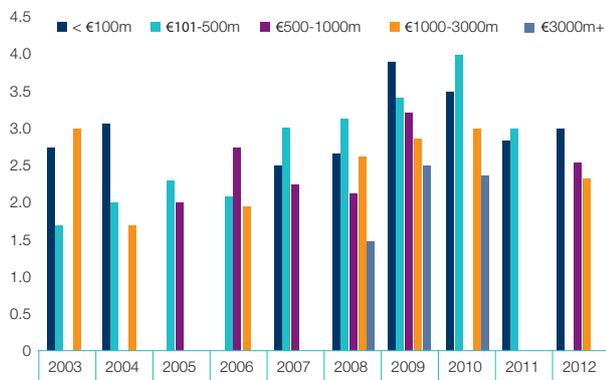
Until the late 1990s rights issues were conducted for the most part on standard terms which had not varied for some time. This changed when standard rates were abolished following the publication of the Monopolies and Mergers Commission report on “Underwriting Services for share offers” in 1999. The financial crisis of 2007-08 put markets under significant pressure and the risks facing underwriters were significantly greater than for some considerable time. Understandably, gross fees and discounts rose as both underwriters and sub-underwriters required more reward for the risk they were assuming. Since then, however, fees have remained high.

As reported by the Institutional Investor Council in the Rights Issue Fees Inquiry in December 2010, no “plausible justification” could be found for the rise in fees which has taken place since the Monopolies and Mergers Commission conducted an investigation into the matter in 1999.

The chart below illustrates how the gross fees have varied over the period from 2003 to 2012. As illustrated in Figure 11, the period up to 2008, was characterised by low numbers of issues and low average values. Based on the sourced data for the chart below, average fees for rights issue rose to over 3% in 2009 and 2010 from a range of 2.2% – 2.8% over the years from 2003 to 2008.

Rights Issue fees and associated issues are discussed in Section 4.3. in more detail.

Figure 15. Average Fees for Rights Issues in the UK (gross fee, %)



Source: Dealogic

4. KEY ISSUES WITH SECONDARY OFFERINGS

4.1. Pre-Emption

The concept of pre-emption is widely acknowledged as a great strength of raising equity capital in the UK.

There is also widespread acknowledgement that, while it can sometimes appear overly structured to an outsider, the system worked well and was flexible enough over 2008/09 to be able to recapitalise companies in a time of significant financial stress and crisis.

There is no significant desire amongst any party we consulted to change the UK process of pre-emptive capital raising for listed companies for issues of more than 10% of issued share capital.

There is, however, significant debate around the role, size and flexibility of non-pre-emptive issues of less than 10% of ordinary share capital.

The EU Prospectus Directive allows issues of up to 10% in any rolling 12 month period to be executed without a prospectus. Such placings are therefore not available to retail investors.

The existing Pre-Emption Group Statement of Principles approves of placings for cash on a non-pre-emptive basis of up to 5% of ordinary share capital in any one year and up to 7.5% in any rolling three-year period. Although these Principles state that any discount should not be greater than 5%, including placing related expenses, and that the discount should be made in reference to the price immediately prior to announcement, market practice has developed to calculate the discount with reference to the price at the time of pricing.

In addition, the ABI has also provided guidance that its members will not require clawback for directly acquisition-related equity financing, in the form of a vendor placing, of up to 10% of capital at a discount of no more than 5%, though the reference price for measuring the discount is not clear.

The UKLA has recently clarified its requirement that all placings should be priced within a 10% discount to the middle market price at the time of agreeing the placing.

Investors have in the past expressed disquiet over the use of the cash box to raise capital for purposes other than genuine, directly acquisition-related financing.

However, as the practice has become more common, there has been a greater acceptance by some investors of the flexibility that raising up to 10% offers to their investee companies, despite the ABI discouraging the practice in a letter to FTSE100 Chairmen in February 2009.

Investors value highly being consulted ahead of all placings, particularly of those greater than 5% of ordinary share capital in any one year, to solicit their opinion and support. Equally, the sell side are keen to engage with investors ahead of placings to help ensure that a transaction is well received, priced favourably and to minimise their own underwriting risk.

There is a strong expectation from most investors that they will, in practice, be able to “stand their corner” i.e. maintain their percentage holding in the company if they desire in any non-pre-emptive placing, and this is respected by all the banks and brokers we have consulted.

Issuers and advisers appreciate the extra flexibility that raising up to 10% on a non-pre-emptive basis offers in terms of speed and cost.

UK companies listed on AIM, subject to the Companies Act 2006, have greater flexibility with regard to the disapplication of pre-emption rights. The Pre-Emption Group Statement of Principles on non-pre-emptive cash placings are aimed at companies with a Premium listing, but AIM companies are also encouraged to comply. However, it has become common practice for AIM companies to seek a disapplication of at least 10%, and often higher, and investors generally accept the need for this greater flexibility.

Overall, there is some confusion in the market as to what is acceptable under the Pre-Emption Group’s Statement of Principles or ABI guidelines as to what is acceptable for investors in non-pre-emptive issues.

Conclusions

The system in the UK for raising new equity capital for already listed companies is fit for purpose.

Pre-emption, as the cornerstone of this system, is a major strength and remains highly valued by investors.

Raising more than 10% of issued share capital for companies listed on the Main Market should always be done on a pre-emptive basis, unless otherwise approved by shareholders for specific reasons in specific circumstances. In any event, raising more than 10% will require a prospectus.

The greater flexibility offered to companies traded on AIM is appropriate.

Greater flexibility in the issuance on a non-pre-emptive basis of up to 10% would be valued by issuers and their advisers. The use of cash box structures means that, in practice, such flexibility exists for many companies.

Investors remain concerned about the potentially dilutive effects of non-pre-emptive issues. In all such issues, they attach great weight to being consulted ahead of non-pre-emptive placings and being given the opportunity, in practice, to “stand their corner”.

Greater clarity is needed surrounding what is acceptable to investors in relation to non-pre-emptive placings.

Key Recommendations

The ABI will clarify its existing guidance on non-pre-emptive placings, open offers and rights issues.

The Pre-Emption Group should be reconvened with a view to assessing the scope and suitability of their Statement of Principles in the light of market practice.

At least, the revised ABI guidance and Statement of Principles should provide clarity on:

- the limit for placings for cash, including aggregate issuance over a time period longer than one year, and associated discount,
- the limit for vendor placings conducted on a non-pre-emptive basis and associated discount,
- the acceptability or otherwise of the cash box when not used as directly acquisition linked financing,
- acceptable levels of capital raised and associated discounts for open offers,
- the reference price when calculating discounts, and whether fees associated with such issues should be included, and
- the application of such Principles or guidelines for the Standard segment and AIM.

Major existing institutional shareholders should be consulted in advance of non-pre-emptive placings.

4.2. Underwriting Capacity, Fees and Discounts

Underwriting Capacity

There were mixed views concerning the underwriting and sub-underwriting capacity in the London market. All participants said that the very busy period of recapitalisation of UK plc during the financial crisis in 2008/09 provided an important test for this capacity.

Primary underwriting capacity was generally acknowledged to remain substantial. Although, in 2008/09, investment bank risk committees may have been cautious given the substantial amount of underwriting risk they were being asked to take on in such volatile times, we are not aware of any issue that was not completed because of a lack of capacity. However, substantial comfort was given to the banks by seeking soft commitments from potential sub-underwriters for most or all of the issue before signing the primary underwriting agreement with the issuer.

Capacity was also encouraged by a substantial widening of discounts and an increase in fees in capital raisings.

There were wider views on whether there was a capacity problem with sub-underwriting in the London market.

Once again, in 2008/09, participants agreed that there was, overall, sufficient capacity for the large number of issues.

However, there were differing opinions on whether the traditional source of sub-underwriting capacity, the long-only UK institutions, was sufficient:

- on the sell side, brokers to the small and mid-cap area of the market did not feel there was a capacity problem from the traditional source, whilst brokers to the larger companies disagreed,
- investors' opinions were also mixed, though a significant number of institutions indicated that there was a reduced appetite for sub-underwriting for a number of reasons, including:
 - reduced equity weightings caused by regulation and Liability Driven Investment (LDI),
 - mandate restrictions particularly for non-UK clients, and
 - a reluctance or ban on sub-underwriting offerings where the institution is not an owner of the shares ahead of the issue ("naked sub-underwriting").

As traditional capacity has waned, non-traditional sources of sub-underwriting capacity, such as hedge funds and banks, have grown.

All parties agreed that it was important to have the bulk of issues sub-underwritten by existing institutional shareholders. They are seen as more "natural" holders of any shares not taken up or subsequently placed. In such circumstances, should shares be left with the underwriters, they are more likely to be held rather than be sold or hedged following an unsuccessful failed issue, so helping to minimise further pressure on an already weak share price.

However, investors emphasised that agreement to sub-underwrite a transaction should not be seen as a signal that the sub-underwriter will vote in favour of the issue or related transactions.

Fees and Discounts

Some sell-side participants argue that sub-underwriting fees had to rise significantly during the financial crisis because of a lack of appetite and capacity from the traditional UK institutions, despite the increase in discounts at this time. Capacity from less traditional sub-underwriters such as hedge funds was also limited at this time.

As noted in the Rights Issue Fees Inquiry, the split of risk and reward may not always be appropriately split between primary and sub-underwriters. This view was expressed by most participants on the both the buy- and sell-side.

Primary underwriters bear the risk associated with the issue from when they sign the underwriting agreement - typically the night before the announcement of the rights issue or open offer - to the moment sub-underwriting commitments are signed by the sub-underwriters. This is typically 24 to 48 hours after announcement.

However, the extent of risk borne also depends on whether the primary underwriters lay off the entire risk to sub-underwriters. Some banks intentionally retain a portion of the risk on their balance sheets to increase their retained fees. Investors have expressed concern over this practice because they see the banks as "unnatural" holders of the shares, in the event that an issue fails and stock is left with the sub-underwriters.

The risk assumed by primary underwriters is often mitigated during a pre-marketing process in the days leading up to announcement to gain support for the issue. Large shareholders are taken inside or "over the wall" and briefed on the issue to enable them to evaluate it and indicate their sub-underwriting commitment.

Sub-underwriters typically carry the risk for approximately

2 – 3 weeks depending on the exact timetable and the requirement for a shareholder meeting. Investors who act as sub-underwriters argue that primary underwriters should reduce their fees to reflect their shorter and more limited risk period.

It is, however, difficult to ascertain precisely the split of fees between the primary and sub-underwriters as the primary underwriting fee is bundled within the overall fee or “gross spread” for the transaction, alongside the advice, preparation and documentation for the issue.

During and since the financial crisis, it has become more common for UK companies to undertake rights issues at “deep discounts” of approximately 30-40% to the TERP.

Both, buy-side and sell-side, support this development because the level of discount for a rights issue is economically irrelevant for shareholders who take up their rights or sell their nil-pays (although in the latter case, there is a risk that the actual sale price of the nil-pays may not reflect their theoretical economic value). It is, however, difficult to quantify the extent to which this affects shareholders’ interests in practice.

Deep discounts reduce substantially the risk of the share price falling below the exercise price of the rights issue, and therefore of the issue being unsuccessful, either because it has resulted in a low level of take up and the need for a large rump placing, or by being left partly or in whole with the sub-underwriters.

However, companies are often resistant to deep discounts because they believe it sends a signal to the market that the company is in distress, despite strong advice from advisers to the contrary.

Open offers, on the other hand, are required to have smaller discounts (below 10%) as existing shareholders are unable to monetise the value of their entitlement if they cannot take it up. They are therefore typically used for smaller pre-emptive capital raisings so that value leakage is minimised for those shareholders who do not take up their entitlement. Some sell-side advisers actively steer their clients away from open offers, even for small capital raisings, in favour of a rights issue, for this reason.

While there has been a significant increase in the discount on rights issues and also, since 2008/09, a drop in volatility in the market, it is difficult to determine whether there has been a commensurate decrease in the risk-related element of rights issue fees. This, once again, is because of a lack

of transparency between the three elements of the fee – advice/preparation/documentation, primary underwriting and sub-underwriting.

Investors argue that companies should continue to adopt the deep discounted structure and should focus their efforts on reducing fee levels. They have said that they are willing to see their sub-underwriting fees reduced for the lower level of risk that a higher discount entails. However, at the same time, they expect to see a fall in the risk-related fees that investment banks retain. They regard the current fee split between primary and sub-underwriters as unfair, given the difference in the underwriting periods.

At very large discounts, for a company that is not raising money from a position of distress, there will come a point where both primary and sub-underwriting fees ought to become negligible. It was suggested by one participant that, at discounts below 50%, there should be no underwriting fee at all.

However, this would not provide the absolute certainty of funding required by most companies. Pre-emptive capital raisings, whether rights issues or open offers, have almost exclusively been underwritten over the last decade as companies and their advisers have shown a significant reluctance to announce a transaction without certainty that the funds will be forthcoming, particularly when related to acquisition financing and the requirements of the Takeover Code. The last “plain vanilla” non-underwritten, deeply discounted issue, for Cookson in 2002, was difficult and not seen as a success³⁶.

There is therefore probably an absolute minimum fee level, regardless of whether it is appropriate from a risk/reward point of view, at which sub-underwriters will no longer be prepared to take on the commitment.

A balance therefore needs to be struck between lowering the fees through increasing the discount and providing certainty of funding, if companies are unwilling to launch non-underwritten issues.

It has been said that company management are not focused on the fees for raising capital because they lack experience in the process. To help address this, the Office of Fair Trading (“OFT”) enquiry encouraged companies to ensure that their boards had relevant experience in this area. Some independent advisers believe that companies require assistance in ensuring that the fees they are quoted by their corporate brokers are competitive.

³⁶ In 2003 and 2005, United Utilities conducted a novel two part non-underwritten rights issue, with each part falling in to a different part of the regulatory cycle, separated by a regulatory review. It was not practical to have the transaction underwritten, given the two years between the issues. Instead half a share was issued in each part, with the two halves being combined once the second issue was completed. The issue was issued at a 32.8% discount to TERP at the time of the first part, and both parts were completed successfully.

Other advisers and brokers said that issuers are alert to the concern among investors about rights issue fees, specifically because of previous inquiries by the OFT and the Institutional Investor Council. Companies typically now ask their advisers to provide precedents for any fee quotation, including details on discounts on previous deals, as part of the overall consideration. In addition, in the pre-marketing phase, investors actively engage with companies to find out what process they have gone through to ensure that the fees are kept at a minimum.

Another reason that has been given for the level of fees is that secondary issues are seen as an opportunity to reward long-standing advisers for, possibly, years of advice for which little or nothing has been paid. This tends to make fees structurally uncompetitive because long-standing advisers/brokers are usually appointed to lead on rights issues without going out to tender.

It has been previously proposed by some, including the OFT enquiry, that companies should be encouraged to go to tender for the risk part of a transaction as this may reduce overall fees. The preparation/documentation would be carried out by the adviser/corporate broker(s), with the tendering of the underwriting occurring at the very end of the process, shortly before announcement and sub-underwriting thereafter. To enable this to happen, corporate brokers/lead advisers would need to be paid a market-value fee for any work they carry out or a retainer for their services over the months or years in between capital market or M&A transactions. This approach could have significant consequences for the UK corporate broking model.

Many parties, in particular the companies themselves, have a concern that tendering the primary underwriting could lead to a leak of sensitive information to the market. Some independent advisers, however, believe that tendering the primary underwriting, for both discount and fee, could be achieved without information leakage. They point to examples in Europe of this model functioning well.

It has also been proposed that a tender process could be used to allocate sub-underwriting and set its fee level. This was briefly tried in the mid-1990s, but with limited success. It was considered by institutions to be too complicated and discouraged many from participating. It resulted in greater participation of “unnatural” holders of shares (e.g. investment and lending banks) in the sub-underwriting. We found no appetite from any participants for this process to be restarted.

There have been a number of recent transactions (e.g. issues by Drax and Resolution), where investors have signed firm sub-underwriting commitments ahead of announcement, thereby avoiding the need for any primary underwriting fee on that portion of the transaction. Although these transactions have relied on a relatively concentrated shareholder base, it demonstrates that strong and early shareholder support can also help reduce overall fees in a capital raising.

Neither fees nor discounts to the market price at the time of agreeing the placing are typically made public in non-pre-emptive placings.

Conclusions

Overall, there is sufficient primary and sub-underwriting capacity in the UK market. However, capacity from the traditional sub-underwriters in the UK has reduced.

There is agreement amongst most parties that the split of risk and the reward for taking such risk between primary and sub-underwriters could be improved.

Deep discount rights issues should be encouraged as a way to lower fees.

There may however be a level of fees where it will be difficult to attract traditional UK institutional sub-underwriters; even if the discount is high and so risk is low. Too low a fee could lead to substantial proportions of a transaction being sub-underwritten with “unnatural” counterparties, or not sub-underwritten at all. Long-only institutions need to balance their desire to see a transaction fully sub-underwritten by “natural” long-term holders with the minimum size of the fee they are prepared to enter in to such sub-underwriting commitments.

It is currently difficult to reconcile the risk to each underwriter and sub-underwriter with the reward they receive because of a lack of transparency of a bundled fee.

An unbundled fee, and transparency on other capital raising associated costs, will enable all parties to reconcile risk with reward, understand the true costs of preparation of the rights issue, and allow greater clarity, where appropriate, in setting the different fees for different roles within the issue.

Tendering for primary underwriting could, in principle, lead to a reduction in fees. However, we believe having the transparency of an unbundled fee is likely in the first instance to introduce a tension that will lead to more competitive primary underwriting fees.

Tendering could also lead to a lower desire or ability of the primary underwriters to pass on the risk, because their underwriting fee may be absorbed to an unattractive extent by the fee paid to sub-underwriters.

There is no desire from any party to tender for sub-underwriting. Tendering might in principle bring down fee levels, but at the same time result in a greater proportion of issues being sub-underwritten by unnatural holders.

In order to make the process more efficient, it is likely that more standard sub-underwriting documents, negotiated well ahead of time, should be used. These may have to be negotiated on an institution by institution basis, unless a more general document can be agreed amongst all parties.

For non-pre-emptive placings, it is difficult for the market to see, particularly on a retrospective basis, whether fees are competitive and transactions are being priced appropriately. Greater transparency is therefore needed for the fees and discounts in such transactions.

Key Recommendations

Companies should use deep discounts in rights issues in order to reduce the level of underwriting fees paid to both primary underwriters and sub-underwriters. They are also encouraged to reduce primary underwriting fees where possible by getting firm undertakings from sub-underwriters prior to announcement of the transaction.

The gross spread for rights issues and open offers should be unbundled, such that the amounts for advice, including document preparation, primary underwriting and sub-underwriting are shown separately. These unbundled fees should be fully disclosed in the offering documents, along with disclosure of other rights issue-related fees including, but not limited to, lawyers, accountants and independent advisers.

There is no legal requirement for the disclosure of disaggregated fees. As the disclosure requirements are contained in the EU Prospectus Directive, which is a maximum harmonisation directive, it is not feasible to change primary legislation or regulations in the UK to require such disclosure. However, investors would like to see disaggregated disclosure as a matter of best practice.

Tendering for both primary and sub-underwriting should be pursued only if the unbundling of fees does not lead to a lowering of the overall fee levels.

We encourage both buy side and sell side to develop standard sub-underwriting agreements. This would help to make the

sub-underwriting process more efficient particularly if institutions are engaged ahead of announcement, which in turn should lead to a reduction in overall fees.

The aggregate fees charged and the discounts to the mid-market price at the time of agreeing the placing should be disclosed in the pricing announcement for non-pre-emptive placings.

4.3. Timetable

The timetable for a pre-emptive issue can be divided in to two parts – private (i.e. before the transaction is publicly announced) and public (i.e. the period after announcement in which any general meeting and the offering will take place).

The public timetable was shortened for both rights issue and open offer in 2009. This was widely supported by all parties we consulted.

There were a number of parties on both, sell- and buy-side, who felt that the public timetable could be shortened further. Some of the processes that require a two week offering period (after any general meeting) are driven by either outdated methods of communication or a lack of efficiency in the taking up of rights or entitlements.

Evidence of the redundancy of the back end of the timetable is shown in the typical substantial fall-off of volume in the last two days of a typical rights issue. Two areas in particular are:

- the need to post physical documents in an era of electronic communication and dematerialisation, and
- the long notification period that custodians require to guarantee successful exercise of rights (at least two business days and in some cases up to seven days).

Investment in these areas could reduce the timetable further, which would reduce the period on risk for underwriters and therefore the cost of the capital raising.

Advisers and issuers felt that the 10 weeks needed between kick-off meetings and announcement to prepare a pre-emptive offering is overly long. Large capital raisings are often related to M&A transactions or distressed financings, both of which are time critical. There is a competitive disadvantage in the former, and a potentially dangerous period of instability associated with the latter, that make any shortening of the preparation of an offering highly attractive.

The 10 week timetable is substantially determined by the

documentation, preparation and review period between the Sponsors and the UKLA. It has been suggested by Sponsors and lawyers that an accelerated review process for time critical offerings, as is available in France and Spain, would add to the attractiveness and competitiveness of the UK market. They recognise that an increase in UKLA fees to provide this service would be appropriate.

Conclusions

Most parties would welcome a further shortening of the public phase of the offering timetable.

In addition, it is important to consider ways to reduce the preparation time needed for an offering requiring a prospectus.

Key Recommendations

Efforts could be made to shorten a pre-emptive offering timetable further by examining ways to eliminate physical distribution of documents and reducing the time needed by custodians to enact their clients' instructions to exercise.

The UKLA should investigate the feasibility of introducing a fast-track review process for time critical offerings. Issuers should expect to pay higher fees for any extra resources needed for the UKLA to provide this service.

For more information

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