Local Authority Pension Fund Forum

LAPFF Response to UK Listing Authority Consultation DP/CP17/04 'Review of the Effectiveness of Primary Markets: The UK Primary Markets Landscape'[1]

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The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 73 public sector pension funds based in the UK with combined assets of approximately £200 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest. The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

SUMMARY

LAPFF overall conclusion is that the UKLA - being located within the FCA - is in the wrong place. The FCA's objectives (consumer protection) are not the same as the Listing Rules objectives of investor protection. This is for a variety of reasons.

Some FCA functions may positively conflict with that objective. That includes prudential regulation, as there may be times when capital raising is in the regulator's interest but not the shareholder interest, the Royal Bank of Scotland's 2008 rights issue being a case in point. It was quite clearly an objective of the FSA to have shareholders bail out the bank with new capital. However the scale of existing embedded losses that have since emerged in that bank have revealed how unreliable the accounts and the prospectus were for investor protection purposes. So long as the UKLA (investor protection) function is under the same roof as any prudential function, it might be expected that the prudential function would get the paramount attention.

The recent events regarding Tesco are also examples of conflicting objectives. The FCA as market regulator has imposed a penalty on the company, payable as compensation to a specified group of investors who bought in a specific time period. That is a novel regulatory approach for the UK and runs against basic principles of investor protection and breaks with the fundamental principle of treating all shareholders equally. It is also disappointing that shareholders' funds are seen as the first port of call for compensation, not the directors personally, or the auditors.

There also needs to be clarity as to the investor protection provided by Listing Rules and the investor protection provided by company law. The current regulatory framework has significant problems, not

[1] https://www.fca.org.uk/publications/consultation-papers/review-effectiveness-primary-markets

least due to the FRC not dealing with existing company law protections properly. This has implications for the Listing Regime. For instance banks made rights issues when their accounts were obscuring the fact (due to lack of provisioning) that the bank was really balance-sheet insolvent.

There are also issues around admission to listing where there is limited free float and/or there is a controlling party. This creates conflicts and may place too much reliance on the company law and ‘comply or explain’ corporate governance regime to resolve. In some cases it has been clear that the comply or explain approach does not function when public shareholders are not able to control the composition of the board to hold it to account.

LAPFF does have some concerns about the governance of the UKLA, but believes that the UKLA, being a function within the FCA, is in the wrong place irrespective of dealing with the governance of the FCA. The problems, in the view of LAPFF, are worsened given the problems with the FRC’s role in the regulatory framework, and the fact that a former Big Four Chairman is the Chair of the FCA. It is clear to LAPFF that issues with defective accounting have not been dealt with by either the FRC or the FCA as Listing Authority.

INTRODUCTION

LAPFF welcomes the opportunity to respond to the Consultation. As an investor forum, LAPFF believes that addressing the rules pertinent to the listing regime is essential to safeguard the interests of pension fund beneficiaries.

All of our comments should be taken in the context that we consider the Discussion Paper (DP) and Consultation Paper (CP) are consulting in good faith and are well researched. The DP has especially good coverage of issues with relevant statistics in appendices.

We have set out our additional views on a series of issues in narrative form, over and above the CP questions regarding the general focus of the listing regime regarding investor protection versus other interests (mainly service providers). Given the extent of indexing in many large institutional portfolios, the decisions that the UK Listing Authority (UKLA) makes can amount to forced investment decisions.

We also comment on the structural position of UKLA, which we consider is also pertinent given the recent BEIS Green Paper on Governance and Brexit. We stress that the recommendations we make, in the context of the UKLA, are by no means a criticism of that body or it’s personnel, or the Financial Conduct Authority (FCA). However, we believe that the listing regime is not a function that is best placed within the FCA.

PRIMARY ISSUES

The main issues we have covered separately are:-

A the extent to which the listing regime is driven by the objective of investor protection (as described in 2.9), or whether other factors are allowed to dilute that

B collateral and economic issues, which are additional to the broad point covered in A above, in particular:-

- confusing listing matters by references to other government policy objectives (such as scientific policy 1.20-1.22)
- prudential regulation. We raise this because some objectives of prudential regulation may conflict with the UKLA function, particularly in relation to banks and capital raising

C we set out our initial view for discussion, that the best place for the UKLA is not under the FCA

D the effect of Brexit, in particular any effect that may have on the Premium versus the Standard Listing

A The DP states that the purpose of Listing Rules is investor protection.

The DP, para 2.9, states that the primary aim of the listing rules is investor protection from harm caused by issuer misconduct, market misinformation, errors and market misconduct. In this context we take 'investor protection' to refer to shareholders and creditors and other forms of investment,

The issuer perspective is a factor to take account of, but companies can raise capital off-market through private equity for example. Rules around public markets have accumulated over the years due to the increased agency problem in widely dispersed ownership (lack of access of the principal to the agent). Company Law then deals with the risk from the hazard of limited liability (e.g. see November 2016 BEIS Green Paper).

However, the clarity of 2.9 is clouded as there is then inconsistency elsewhere in the DP and CP. In particular the term 'stakeholder' is used frequently in the DP. The use of 'stakeholder' makes it unclear where impetus for change is coming from, when the term is applied to describe the source. This therefore creates the scope for invisible lobbying by the parties that are the problem that the listing rules are there to deal with.

The position of the actual parties behind the veil of 'stakeholder' needs to be more transparent. Rather than 'lobbying' on issues, LAPFF often responds to attempt to mitigate and counteract the effects of other parties' lobbying. LAPFF considers that the listing regime is particularly vulnerable to that; as we have also encountered this in capital standards for banks and accounting standards

Para 2.17 of the DP does helpfully set out that the population of stakeholders is 'issuers, investors, sell-side firms, and advisers', and para 1.27 refers to the markets 'meeting the needs of issuers and investors'. But, going back to first principles, the risk to investors can variously be from directors and management, advisors (including sell-side firms, law firms and auditors), or, in some situations, rogue investors (market abuse) or a large controlling or near controlling party.

All of the reasons why the London market is a strong market are stated, which is all the more reason that standards should not be eroded. There is a danger in assuming that issuers are takers of capital, when the reality is that investors are the providers of it. Higher standards are beneficial to investors and bona fide issuers alike. (This is covered in more detail under D below with examples).

Related to this are the issues of delivering other government policy objectives, and prudential regulation.

B Collateral and economic issues

Link of listing with supply of capital to the economy.

Given the international nature of companies listed on the London market we do not think it is necessarily correct to link the capital markets with the flow of funds to the wider UK economy, as in 1.1 of the DP. We do not disagree with that occurring, clearly, but the nature of the London market – given that it comprises companies that are predominately invested in non-sterling assets – creates a significant risk of overplaying both that effect and benefit. Funds for investment in many cases will not flow to the UK economy at all, and some mineral companies are a good example of that.

Government policy and fiduciary duties

As an association of Local Authority pension funds, we are only too aware of the need to separate the investment objectives of the funds, which must be in the interests of the beneficiaries and local taxpayers, from other competing objectives. This can be relevant in the context of issues around pressure for localised investment and in some cases pressure for divestment. We were therefore surprised in principle to see direct reference in para's 1.20-1.22, and then Chapter Four, to changes to the Listing Rules on the basis of the government green paper 'Building Our Industrial Strategy'. We are not in a position to comment one way or the other on that strategy; our concern is the linking of that strategy to changes to the Listing Regime that go against sensible, well founded principles of investor protection. That concern is heightened given that that policy objective is being specifically linked to allowing dual class share structures. That is not only something that we disagree with but also is a red herring. There is no need to achieve that policy objective with dual class structures.

Prudential Regulation

Para 1.5 of the DP does, we accept, only refer very lightly to potential cross cutting issues with prudential regulation, and generally we would see overlapping objectives. For example bona fide investors would not support share price manipulation that may have financial stability implications, as false signalling. However, there is a clear example of where there is a direct conflict between the purpose of the Listing Rules and prudential regulation and that is the matter of capital raising in banks. The objective of the prudential regulator to cause new capital to be raised, may create a significant conflict with the protection of existing long term shareholders. At the moment two shareholder actions are taking place in the context of Lloyds/HBOS and RBS. There is a strong case that there was a conflict for the FSA as a prudential regulator and the UKLA.

C Placing of the UKLA

The part of the FCA outside the UKLA is focussed on consumer protection (and via conduct in banks especially, wider public protection). However, the UKLA being part of the FCA is somewhat anomalous as it was not originally intended to be part of the FCA's forerunner, the Financial Services Authority (FSA), but was transferred once the London Stock Exchange demutualised and no longer provided a suitable 'home' for the listing authority.

We consider that there may be a case for refocussing the position of the UKLA, to be separate from the FCA, with direct Parliamentary scrutiny of its governance and activities. It is also a general principle that where there are transfers of value between one group of stakeholders and another that primary legislation is the correct mechanism for that to be delivered. Until relatively recently, key aspects of the Listing Regime was specified in Company Law[2]. In our view this change enabled a more laissez faire attitude to Listing requirements to take hold.

We further consider that the real conflict between prudential regulation (see below) and protection, in the case of primary share issues, creates an imperative for separation. We do not see how one FCA board can deal with that tension, given the overlap between the FCA board and that of the PRA. In its response to the BEIS Green Paper, LAPFF has called for the establishment of a Companies Commission to deal with the problems with the FRC. The UKLA may well belong better in such a Companies Commission. We stress that this recommendation is by no means a criticism of the UKLA's personnel.

D Brexit: Premium and Standard listing

The consultation paper is clear that there is a preference for the Premium Listing, which is determined by UK law and governance standards, and which is above the requirements of EU Directive and Regulation, the Standard Listing. The Standard Listing exists to avoid discrimination against the EU minimum standard. However, against the statement that Premium is the preferred option, there are then various points set out that indicates facilitation of listings to less than the Premium standard (see below). We also note that 2.27 indicates that parties considerer 'Standard listing' to be of lesser quality even of that required for AIM. Indeed AIM listing requirements remain wholly inadequate for shareholder protection in the current model.

However, we don't think that a decision can, or should be taken on Primary vs Standard listing at this stage, given that the position will be an issue which is dependent on Brexit negotiations and then outcome, unless a rational basis is provided for assuming that the two models will still be required irrespective of the pending negotiations.

There are issues with the Standard Listing that we are particularly concerned about in relation to overseas issuers. Rights are enshrined in company law; codes are generally not enforceable. There is a problem in creating codes to replace rights that overseas issuers lack. The US system has regulatory rights with tougher enforcement by the SEC, largely to substitute for a lack of explicit company law requirements in states such as Delaware.

The matter of Rights issues is a crucial element of investor protection. We note that that there can be confusion over the two essential elements:

- economic dilution
- voting dilution

We are concerned that there should be measures to ensure the prevention of both forms of dilution.

[2] Part III of the Companies Act 1985

In attempting to achieve equivalence with UK Company law for overseas issuers by overlaying additional codes, we consider that company law is increasingly relevant compared to voluntary codes. We further do not accept that 'disclosure' is a substitute to investor protection.

Paragraphs 1.14 - 1.15 which refer to changes to be made for overseas issuers in the context of Global Depository Receipt ('GDR') is cumbersomely worded and seems to suggest a route to let bad companies in through the back door. This is where the 'stakeholder' problem is particularly notable. The question for us is which 'stakeholders' are pushing for what changes and why? The same problem is apparent in para 1.18, this time with unspecified 'stakeholders' undermining criteria for Premium listing. This is anomalous as para 2.18 is clear that the support for the UK market is particularly focussed on the Premium market.

Issues arising from the statistics

In general, we consider most of the supporting data to be strong. An example is the data in figure 3, page 45, 'Reasons for delisting'. This issue of insolvency is of particular interest, as it clearly involves a loss of value, as opposed to a transfer to another asset/class of asset. The total number of insolvencies for the seven years covered is 53 companies on the main market, with 69 for AIM. That is a significant number, given that the investment loss is absolute, cumulative and permanent, that implies a loss of 5% of total return[3].

Arising from that observation, we consider that it would be useful for there to be a more formal and regular framework for following through insolvencies with the reasons for each of these cases. Essentially we are suggesting a form of 'post mortem' analysis, as there may be policy relevant observations and implications that could help mitigate such risk going forwards. For example, any systemic flaws in the auditing and financial control process may be relevant and more easily identified through this process. We note that the FRC, for example, does not have a systematic approach to dealing with corporate or auditing and accounting failure.

Relevant to this is our observation that neither the FCA or the FRC has commented on, or investigated, the failed (by reference to subsequent events) rights issues of certain banks in 2008. On that issue neither body appears to have had accountability for, let alone rectified, the distinct lack of investor protection in practice. The overlap for some individuals between the boards of the FCA with the FRC and with the large accounting firms adds to our concern on this.

[3] E.g. of the main market starting as 1,000 companies (which is an overestimate) then the investment loss could be at least 5%, assuming equal distribution over market capitalisation.

QUESTIONS

Q1: Do you agree with the proposals to clarify the requirements discussed above regarding the historical financial track record and revenue earning track record requirements for premium listing eligibility?

Yes. We agree on the basis this is an explicit clarification of existing implicit requirements and not a dilution of requirements.

Q2: Do you agree with our proposals to split the current independent business requirements into three distinct areas with associated guidance?

Yes. We believe that having separate clarity on each of the requirements is important.

Q3: Do you agree with the other proposed minor clarifications to LR 6?

Yes.

Q4: Do you agree with replacing our existing Technical Note – Scientific research based companies (UKLA/TN/422.2) with our proposed Technical Note for SRBCs (UKLA/ TN/422.3)?

Yes, subject to our comments earlier on issues with the listing rules being a mechanism to deliver government policy outside of the scope of the core principle of investor protection.

Q5: Do you agree with our proposals to introduce a new Technical Note for mineral companies (UKLA/TN/427.1)?

We would need more convincing arguments on this issue in order to proceed. Mineral companies have been around since listed markets started, and issues of discovery and cyclicality are not new, the economic risks remain the same. We would tend not to be supportive of more concessions for that sector. We are alert to those concessions which allowed companies such as Vedanta, ENRC and others to list, and consider that these cases have not presented a case that relaxation has been beneficial.

Q6: Do you believe a specific concession for property companies in LR 6.12 is appropriate? If so, is the proposed concession correctly calibrated and do you agree with our proposed new Technical Note – Property company concession (UKLA/TN/426.1) in Appendix 1?

No. Similarly, to the comment on mining in QQ5 above, we are not convinced of the need to change the requirements for property companies.

Q7: Do you agree that it is reasonable for a premium listed issuer, having obtained the guidance of a sponsor under LR 8.2.2R, to disregard the result of the profits test, where the result is 25% or more and the other class test results are below 5%, and the profits test result is anomalous?

No. We believe that any attempt to disregard the result of any of the test should have to undergo prior consultation with the FCA.

Q8: Do you agree that an element of judgement should be applied when deciding whether to disregard the result of the profits test where the result is 25% or more and all other class tests results are below 5%?

No. As Q7 above. Any matter of judgment should be under consultation with the FCA.

Q9: Do you agree that premium listed issuers, having obtained guidance on the class tests from a sponsor under LR 8.2.2R, should be allowed to make the proposed adjustments to the figures used to classify profits without being required to consult and agree the adjustments in advance with us?

No. As Q7 above. Any matter of judgment should be under consultation with the FCA.

Q10: Are there any other possible enhancements to the calculation of the profits test that could be made?

We question whether aspect of the accounting framework (IFRS) inherently produce material anomalous effects. The 'own credit' issue with IAS 39 is a case in point, but elements for consideration are not limited to that, not least as IFRS can be overgenerous to asset valuations whilst excluding elements of liabilities.

Q11: As an alternative to our proposals, are there any alternative profit measures that should be used either in conjunction with or in place of the current profits test?

In the light of our answer in Q10 above, we believe that there is scope for a wider, more detailed consultation on anomalies that arise due to the accounting framework. There are clearly anomalies that affect prudential regulation, these anomalies also have implications for other companies, including in the context of rights issues. The standard setting process is dominated by issuers and auditors, and those that purport to represent investors in reality tend to be 'users' from the sell-side.

Q12: Do you agree with our proposal to amend LR 10 Annex 1 paragraph 8R(3)(a) and (b) to set out our existing approach to adjusting the figures used to classify assets and profits for transactions that have occurred during the last financial year that are class 2 or larger?

Yes. We support the clarification proposed.

Q13: Do you agree with the related changes to our Technical Note – Classification tests (UKLA/TN/302.1) which are set out in the revised note in Appendix 2 of this CP?

Yes. We support the amendment proposed.

Q14: Do you agree that we should amend the applicable provisions in LR 5.6 to remove the rebuttable presumption of an issuer's listing being suspended upon announcement or leak of a reverse takeover (other than for shell companies)?

No. We support the maintenance of the existing arrangement.

Q15: Accordingly, do you agree that (other than for shell companies) an issuer or, where the issuer is premium listed, its sponsor should no longer be automatically required to contact us as early as possible to discuss whether a suspension is appropriate when a reverse takeover is agreed or is in contemplation, or to request a suspension where details of the reverse takeover have leaked?

No. We support the maintenance of the existing arrangement.

Q16: Do you agree with our proposal to delete the Technical Note – Reverse takeovers (UKLA/TN/306.3) and with our proposed changes to the Technical Note - Listing Principle 2 Dealing with the FCA in an open and cooperative manner (UKLA/TN/209.2) set out in Appendix 4?

No, as a consequence of our answers to Q14 and Q15 above.

Q17: Do you agree with our proposed criteria for the types of issuers who will continue to be covered by the rebuttable presumption of suspension and related provisions?

Yes. We support the maintenance of the existing arrangement.

Q18: In particular, do you agree that we should retain the rebuttable presumption of suspension for shell companies upon announcement or leak of a reverse takeover?

Yes. We support the maintenance of the existing arrangement.

Q19: Accordingly, do you agree that shell companies should continue to be required to contact us as soon as possible (i) before announcing a reverse takeover, to discuss whether a suspension of listing is appropriate, or (ii) where details of the reverse takeover have leaked, to request a suspension?

Yes. We support the maintenance of the existing arrangement.

Q20: Do you agree with our proposed amendments to the Technical Note - Special purpose acquisition companies (SPACs) (UKLA/TN/420.1)?

Yes.